

# **TRANSCRIPT OF RECORD**

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**Supreme Court of the United States**

**OCTOBER TERM, 1962**

**No. 80**

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**MARK E. SCHLUDE, ET AL., PETITIONERS,**

**vs.**

**COMMISSIONER OF INTERNAL REVENUE**

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**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT**

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**PETITION FOR CERTIORARI FILED MARCH 15, 1962  
CERTIORARI GRANTED MAY 28, 1962**

# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1962

No. 80

MARK E. SCHLUDE, ET AL., PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

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[fol. 1]

**IN THE TAX COURT OF THE UNITED STATES****General Docket**

Mark E. Schlude, 459 Beverly Drive, Omaha, Nebraska,  
Petitioner,

Docket No. 69,591 vs.

Commissioner of Internal Revenue, Respondent.

**Appearances for Petitioner:**

Name: Robert Ash, Esq.,

Address: 1921 Eye Street, N. W.,  
Washington 6, D. C.

Carl F. Bauersfeld, Esq., Einar Viren, Esq.

**Docket Entries in Docket No. 69,591**

Date	Month	Day	Year	Filings and Proceedings
Aug. 29, 1957				Petition filed: Fee Paid 8/29/57.
Aug. 29, 1957				Request by petr. for trial at Omaha, Nebraska. Granted Sept. 11, 1957.
Oct. 4, 1957				Answer by resp. filed.
Dec. 24, 1957				Notice of trial 3-24-58 at Omaha Neb.
Mar. 4, 1958				Motion by petr. to consolidate Dkt. Nos. 62109, 69591, 69593. Granted 3-24-58.
Mar. 6, 1958				Notice of hgr. 3-24-58, Omaha, Neb., on petr. motion.
Mar. 24, 1958				Trial before J. Black at Omaha, Nebraska. Joint Oral motion to consolidate. Granted (62109, 69591; 2, 3). Stipulation of Facts filed at trial. Appearance of Carl F. Bauersfeld and Einar Viren, Esq., filed. Briefs due June 23, 1958. Reply Briefs due July 23, 1958. Submitted to J. Black.

[fol. 2].

Date  
Month Day Year

## Filings and Proceedings

## Under Submission.

Apr. 8, 1958 Supplemental Stipulation of Facts.  
 Apr. 17, 1958 Transcript of Proceedings 3-24-58 filed.  
 June 20, 1958 Motion by resp. for extension of time to July 7, 1958, to file brief. Granted 6-23-58.  
 June 23, 1958 Motion by petr. for extension of time to July 23, 1958, to file brief. Granted 6-23-58.  
 July 23, 1958 Brief for Petr. filed.  
 July 24, 1958 Motion by resp. for extension of time to Aug. 7, 1958, to file brief. Granted 7-25-58.  
 Aug. 5, 1958 Brief for Resp. filed.  
 Sept. 3, 1958 Motion by petr. for extension of time to Oct. 6, 1958, to file reply brief. Granted 9-4-58.  
 Sept. 3, 1958 Joint Motion to correct the transcript. Granted 9-5-58.  
 Sept. 4, 1958 Reply Brief filed by Resp.  
 Oct. 3, 1958 Reply Brief filed by Petr.  
 June 18, 1959 Motion by petr. for leave to call the Court's attention to certain cases. Granted 6-19-59.  
 Sept. 28, 1959 Findings of Fact and Opinion filed Judge Black. Decision will be entered under R. 50.  
 Nov. 19, 1959 Motion by resp. for revision of order "No obj. by petr." Granted 11-23-59.  
 Nov. 23, 1959 Order, that resp. motion is Granted and the Findings of Fact and Opinion of Sept. 28, 1959 is revised.  
 Nov. 23, 1959 Decision entered, Judge Black.

## Appellate Proceedings.

Feb. 3, 1960 Petition for Review by U. S. Ct. of App. for 8th Cir. filed by petr.  
 Feb. 3, 1960 Proof of Service of pet. for rev. filed.  
 Feb. 11, 1960 Agreed Designation of Contents of Record on Rev. filed.

[fol. 3]

## IN THE TAX COURT OF THE UNITED STATES

## General Docket

Marzalie Schlude, 459 Beverly Drive, Omaha, Nebraska,  
Petitioner,

Docket No. 69,592

vs.

Commissioner of Internal Revenue, Respondent.

## Appearances for Petitioner:

Name: Robert Ash, Esq.,

Address: 1921 Eye Street, N. W.,

Washington 6, D. C.

Carl F. Bauersfeld, Esq., Einar Viren, Esq.

**Docket Entries in Docket No. 69,592**

Date Month Day Year	Filings and Proceedings
Aug. 29, 1957	Petition filed. Fee Paid 8/29/57.
Aug. 29, 1957	Request by petr. for trial at Omaha, Nebraska. Granted Sept. 11, 1957.
Oct. 4, 1957	Answer by resp. filed.
Dec. 24, 1957	Notice of trial 3-24-58 at Omaha, Neb.
Mar. 4, 1958	Motion by petr. to consolidate Dkt. Nos. 62109, 69591-69593. Granted 3-24-58.
Mar. 6, 1958	Notice of hgr. 3-24-58, Omaha, Nebr., on petr. motion.
Mar. 24, 1958	Trial before J. Black at Omaha, Neb. Joint oral motion to consolidate. Granted. (62109, 69592; 2, 3). Stipulation of Facts filed at trial. Appearance of Carl F. Bauersfeld and Einar Viren, Esq., filed. Briefs due June 23, 1958. Reply Briefs due July 23, 1958. Submitted to J. Black.

[fol. 4]

Date  
Month Day Year

Findings and Proceedings

## Under Submission.

Apr. 8, 1958 Supplemental Stipulation of Facts.

Apr. 17, 1958 Transcript of Proceedings 3-24-58 filed.

June 20, 1958 Motion by resp. for extension of time to July 7, 1958, to file brief. Granted 6-23-58.

June 23, 1958 Motion by petr. for extension of time to July 23, 1958, to file brief. Granted 6/23/58.

July 23, 1958 Brief for Petr. filed.

July 24, 1958 Motion by resp. for extension of time to Aug. 7, 1958, to file Brief. Granted 7-25-58.

Aug. 5, 1958 Brief for Resp. filed.

Sept. 3, 1958 Motion by petr. for extension of time to Oct. 6, 1958, to file reply brief. Granted 9-4-58.

Sept. 3, 1958 Joint Motion to correct the transcript. Granted 9-5-58.

Sept. 4, 1958 Reply Brief filed by Resp.

Oct. 3, 1958 Reply Brief filed by Petr.

June 18, 1959 Motion by petr. for leave to call the Court's attention to certain cases. Granted 6-19-59.

Sept. 28, 1959 Findings of Fact and Opinion filed Judge Black. Decision will be entered under R. 50.

Nov. 19, 1959 Motion by resp. for revision of order "No obj. by petr." Granted 11-23-59.

Nov. 23, 1959 Order, that resp. motion is Granted and the Findings of Fact and Opinion of Sept. 28, 1959 is revised.

Nov. 23, 1959 Decision entered, Judge Black.

## Appellate Proceedings.

Feb. 23, 1960 Petition for Review by U. S. Ct. of Ap. for 8th Cir. filed by petr.

Feb. 3, 1960 Proof of Service of pet. for rev. filed.

Feb. 11, 1960 Agreed Designation of Contents of Record on Rev. filed.



## IN THE TAX COURT OF THE UNITED STATES

## General Docket

Mark E. Schlude and Marzalia Schlude, Husband and Wife,  
459 Beverly Drive, Omaha, Nebraska, Petitioner,

Docket No. 69593 vs.

Commissioner of Internal Revenue, Respondent.

## Appearances for Petitioner:

Name: Robert Ash, Esq.,

Address: 4921 Eye Street, N. W.,

Washington 6, D. C.

Carl F. Bauersfeld, Esq., Einar Viren, Esq.

## Docket Entries in Docket No. 69593

Month	Date	Year	Filings and Proceedings
Aug.	29	1957	Petition filed. Fee paid 8/29/57.
Aug.	27	1957	Request by petr. for trial at Omaha, Nebraska. Granted Sept. 11, 1957.
Oct.	4	1957	Answer by resp. filed.
Dec.	24	1957	Notice of trial 3-24-58 at Omaha, Neb.
Mar.	4	1958	Motion by petr. to consolidate Dkt. Nos. 62109, 69591-69593. Granted 3-24-58.
Mar.	6	1958	Notice of hgr. 3-24-58, Omaha, Nebr., on petr. motion.
Mar.	24	1958	Trial before J. Black at Omaha, Neb. Joint oral motion to consolidate. Granted (62109, 69591, 2, 3). Stipulation of Facts filed at trial. Appearance of Carl F. Bauersfeld and Einar Viren, Esq., filed. Briefs due June 23, 1958. Reply Briefs due July 23, 1958. Submitted to J. Black.

[fol. 6]

Date  
Month Day Year

Filings and Proceedings

## Under Submission.

Apr. 8, 1958 Supplemental Stipulation of Facts.

Apr. 17, 1958 Transcript of Proceedings 3-24-58 filed.

June 20, 1958 Motion by resp. for extension of time to July 7, 1958, to file brief. Granted 6-23-58.

June 23, 1958 Motion by petr. for extension of time to July 23, 1958, to file brief. Granted 6-23-58.

July 23, 1958 Brief for Petr. filed.

July 24, 1958 Motion by resp. for extension of time to Aug. 7, 1958, to file Brief. Granted 7-25-58.

Aug. 5, 1958 Brief for Resp. filed.

Sept. 3, 1958 Motion by petr. for extension of time to Oct. 6, 1958, to file reply brief. Granted 9-4-58.

Sept. 3, 1958 Joint Motion to correct the transcript. Granted 9-5-58.

Sept. 4, 1958 Reply Brief filed by Resp.

Oct. 3, 1958 Reply Brief filed by Petr.

June 18, 1959 Motion by petr. for leave to call the Court's attention to certain cases. Granted 6-19-59.

Sept. 28, 1959 Findings of Fact and Opinion filed Judge Black. Decision will be entered under R. 50.

Nov. 19, 1959 Motion by resp. for revision of order "No obj. by petr." Granted 11-23-59.

Nov. 23, 1959 Order, that resp. motion is Granted and the Findings of Fact and Opinion of Sept. 28, 1959 is revised.

Nov. 23, 1959 Decision entered, Judge Black.

## Appellate Proceedings.

Feb. 3, 1960 Petition for Review by U. S. Ct. of Ap. for 8th Cir. filed by petr.

Feb. 3, 1960 Proof of Service of pet. for rev. filed.

Feb. 11, 1960 Agreed Designation of Contents of Record on Rev. filed.

## IN THE TAX COURT OF THE UNITED STATES

Docket No. 69591.

MARK E. SCHLUDE, Petitioner.

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION OF MARK E. SCHLUDE IN DOCKET NO. 69591—  
Filed August 29, 1957

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (RC:OMA(OMA):Ap WEF:RCR:mbb) dated July 2, 1957, and as a basis of his proceeding alleges as follows:

## I.

Petitioner is an individual whose address is 459 Beverly Drive, Omaha, Nebraska. The return for the year here involved was filed with the District Director of Internal Revenue, Omaha, Nebraska.

## II.

The notice of deficiency, a copy of which is attached hereto and made a part ~~of~~ this petition by reference, is dated July 2, 1957:

## III.

The tax in controversy is income tax for the year 1952 in the total amount of \$9,264.69.

## IV.

The determination of tax set forth in said notice of deficiency is based upon the following errors:

A. The Commissioner erred in increasing petitioner's "partnership income" in the amount of \$14,104.12 for the year 1952.

[fol. 8] B. The Commissioner erred in determining that the petitioner's share of the distributable income of the partnership, Arthur Murray Dance Studio, for the year 1952 was \$32,893.28.

C. The Commissioner erred in determining that petitioner's income should be increased by the amount of \$24,602.22, alleged to be "deferred income not reported" of the partnership, Arthur Murray Dance Studio, for the fiscal year ended March 31, 1952.

## V.

The facts upon which petitioner relies as the basis for this proceeding are:

A. On June 18, 1946, the petitioner and his wife formed a partnership for the purpose of conducting Arthur Murray Dance Studios in territories authorized by various franchise agreements received from Arthur Murray, Inc., New York, New York. By the year 1950, the partnership had established dance studios in Omaha, Nebraska, Lincoln, Nebraska, and Sioux City, Iowa.

B. The partnership maintains its books of account on a fiscal year ending March 31 and uses the accrual method of accounting. The partners report their income on a calendar-year basis.

C. During the fiscal year ended March 31, 1950, the partnership, Arthur Murray Dance Studio, contracted with students to give them a course of dance instruction. Some of the contracts extended beyond the end of the taxable year in which the contract was made.

D. Students paid the partnership either in cash or by cash and deferred payments.

E. The partnership, using the accrual method of accounting, kept its books of account and reported the income it received from the dancing business when it was earned.

F. The method of accounting employed by the partnership clearly reflects its true income.

[Tel. 9] G. All items of gross income and deductions have been treated consistently since the commencement of the partnership business on June 18, 1946.

Wherefore, the petitioner prays that this Court may hear the proceeding and:

A. Determine that the Commissioner erred in increasing petitioner's "partnership income" in the amount of \$14,101.12 for the year 1952.

B. Determine that the Commissioner erred in determining that the petitioner's share of the distributable income of the partnership, Arthur Murray Dance Studio, for the year 1952 was \$32,893.28.

C. Determine that the Commissioner erred in determining that petitioner's income should be increased by the amount of \$24,602.22, alleged to be "deferred income not reported" of the partnership, Arthur Murray Dance Studio, for the fiscal year ended March 31, 1952.

D. Grant such other and further relief as the Court may deem proper.

Robert Ash, 1921 Eye Street, N. W., Washington 6,  
D. C., Attorney for Petitioner.

*Duly sworn to by Mark E. Schlude, jurat omitted in printing.*

[fol. 19]

## ATTACHMENT TO PETITION

U. S. Treasury Department  
Internal Revenue Service  
Regional Commissioner  
Omaha 2, Nebraska

In Replying Refer To:

RC:OMA(OMA):Ap  
WEF:BCR:bmb

Mr. Mark E. Schlude  
459 Beverly Drive  
Omaha, Nebraska

Dear Mr. Schlude:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1952, discloses a deficiency in tax of \$9,264.69, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise, Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Assistant Regional Commissioner, Appellate, Room 100, Elks Club Building, 108 So. 18 Street, Omaha 2, Nebraska. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the

deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days [fol. 11] after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

Russell C. Harrington, Commissioner, By Ray H. Johnson, Associate Chief Appellate.

Enclosures:

Statement  
IRS Pub 160 (Rev.)  
Agreement Form

ORL 6-14-1  
April 1957

57-2825 IRS-Omaha, Nebraska

#### ATTACHMENT

#### Statement

Mark E. Schlude  
459 Beverly Drive  
Omaha, Nebraska

Year	Income Tax	Deficiency
1952		\$9,264.69

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated July 3, 1956; to your protest received August 31, 1956; and to the statements made in the conferences held on November 20, 1956, and April 9, 1957.

A copy of this letter and statement has been mailed to your representative, Mr. Robert Ash, 1921 Eye Street, N. W., Washington 6, D. C., in accordance with the authority contained in the power of attorney executed by you.

[fol. 12] Taxable Year Ended December 31, 1952

## Schedule 1

## Adjustments to Net Income

Net income as disclosed by return .....	\$20,245.79
Additional income and unallowable deductions:	
(a) Partnership income .....	14,101.12
Corrected net income .....	\$34,346.91

## Schedule 2

## Explanation of Adjustments

(a) Examination of the books and records of the partnership of Arthur Murray Dance Studio discloses that your share of the distributable income for the taxable year ended March 31, 1952, is \$32,893.28. Inasmuch as you reported \$18,792.16, your taxable income has been increased by the difference, \$14,101.12, computed as follows:

Ordinary net income on the partnership return .....	\$ 37,584.33
Add:	
Unallowable deductions and additional income	
(1) Additional income .....	24,602.22
(2) Nonallowable deductions .....	3,600.00
Corrected partnership ordinary income .....	\$ 65,786.55
Your distributable share .....	\$ 32,893.28
As reported on Form 1040 .....	18,792.16
Increase .....	\$ 14,101.12

## Explanation of partnership adjustments:

(1). Ordinary income is increased by the amount of \$24,602.22, computed as follows:

Deferred income not reported 3/31/52 .....	\$131,143.92
" " " " 3/31/51 .....	106,541.70

Adjustment to income .....

\$ 24,602.22



[fol. 13] Your contention that the foregoing deferred income is not taxable in the taxable year ended March 31, 1952, is denied.

(2) Unallowable expenses of partnership:

Partnership expenses are reduced for personal use of automobile .....	\$ 1,200.00
Personal expenses of partners included in partnership expenses .....	2,400.00
Total .....	\$ 3,600.00

Schedule 3

Computation of Tax

Net income, Schedule 1 .....	\$ 34,346.91
Less: Exemptions (1) .....	600.00
Income subject to tax .....	\$ 33,746.91
Tax liability (tentative) .....	\$ 17,203.90
Computation of Alternative Tax:	
Income subject to tax .....	\$ 33,746.91
Less: One-half excess of net long-term capital gain over net short-term capital loss .....	357.67
Balance .....	\$ 33,389.24
Tax on \$33,389.24 .....	\$ 16,960.68
Plus: 52% of \$357.67 .....	185.99
Alternative Tax .....	\$ 17,146.67
Income Tax Liability .....	\$ 17,146.67
Plus: Self-employment tax (as shown by return, not changed) .....	\$1.00
Total tax liability .....	\$ 17,227.67
Tax liability shown by return, Orig. Acct. No. AF 763637 .....	7,962.98
Deficiency of income tax .....	\$ 9,264.69

[fol. 14]

## IN THE TAX COURT OF THE UNITED STATES

ANSWER OF COMMISSIONER OF INTERNAL REVENUE IN DOCKET  
No. 69591—Filed October 4, 1957

The respondent, in answer to the petition filed in the above-entitled case, admits, denies and alleges as follows:

## I.

Admits the allegations of paragraph I of the petition.

## II.

Admits the allegations of paragraph II of the petition and alleges that the notice of deficiency was mailed to petitioner on July 2, 1957.

## III.

Admits the allegations of paragraph III of the petition.

## IV.

A., B. and C. Denies the allegations of error contained in subparagraphs A, B and C of paragraph IV of the petition.

## V.

A. and B. Admits the allegations of subparagraphs A and B of paragraph V of the petition.

C. to G., inclusive. Denies the allegations of subparagraphs C to G, inclusive, of paragraph V of the petition.

## VI.

Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

[fol. 15] Wherefore, it is prayed that the deficiency determined by the respondent be in all respects approved.

Nelson P. Rose, Chief Counsel, Internal Revenue Service.

Of Counsel: Douglas L. Barnes; Regional Counsel, Richard C. McLaughlin, Acting Special Assistant to the Regional Counsel, Internal Revenue Service, 100 Elks Club Building, Omaha, Nebraska.

IN THE TAX COURT OF THE UNITED STATES

Docket No. 69592

MARZALIE SCHLUDE, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION OF MARZALIE SCHLUDE IN DOCKET NO. 69592

Filed August 29, 1957

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (RC-70MA(OMA):Ap WEF:BCR:amb) dated July 2, 1957, and as a basis of this proceeding, alleges as follows:

[fol. 16]

I.

Petitioner is an individual whose address is 450 Beverly Drive, Omaha, Nebraska. The return for the year here involved was filed with the District Director of Internal Revenue, Omaha, Nebraska.

II.

The notice of deficiency, a copy of which is attached hereto and made a part of this petition by reference, is dated July 2, 1957.

III.

The tax in controversy is income tax for the year 1952 in the total amount of \$8,971.55.

## IV.

The determination of tax set forth in said notice of deficiency is based upon the following errors:

A. The Commissioner erred in increasing petitioner's "partnership income" in the amount of \$14,101.10 for the year 1952.

B. The Commissioner erred in determining that the petitioner's share of the distributable income of the partnership, Arthur Murray Dance Studio, for the year 1952 was \$32,893.27.

C. The Commissioner erred in determining that petitioner's income should be increased by the amount of \$24,602.22, alleged to be "deferred income not reported" of the partnership, Arthur Murray Dance Studio, for the fiscal year ended March 31, 1952.

## V.

The facts upon which petitioner relies as the basis for this proceeding are:

A. On June 18, 1946, the petitioner and her husband formed a partnership for the purpose of conducting Arthur [fol. 17] Murray Dance Studios in territories authorized by various franchise agreements received from Arthur Murray, Inc., New York, New York. By the year 1950, the partnership had established dance studios in Omaha, Nebraska, Lincoln, Nebraska, and Sioux City, Iowa.

B. The partnership maintains its books of account on a fiscal year ending March 31 and uses the accrual method of accounting. The partners report their income on a calendar-year basis.

C. During the fiscal year ended March 31, 1950, the partnership, Arthur Murray Dance Studio, contracted with students to give them a course of dance instruction. Some of the contracts extended beyond the end of the taxable year in which the contract was made.

D. Students paid the partnership either in cash or by cash and deferred payments.

E. The partnership, using the accrual method of accounting, kept its books of account and reported the income it received from the dancing business when it was earned.

F. The method of accounting employed by the partnership clearly reflects its true income.

G. All items of gross income and deductions have been treated consistently since the commencement of the partnership business on June 18, 1946.

Wherefore, the petitioner prays that this Court may hear the proceeding and:

A. Determine that the Commissioner erred in increasing petitioner's "partnership income" in the amount of \$14,101.10 for the year 1952.

B. Determine that the Commissioner erred in determining that the petitioner's share of the distributable income of the partnership, Arthur Murray Dance Studio, for the year 1952 was \$32,893.27.

C. Determine that the Commissioner erred in determining that petitioner's income should be increased by the [fol. 18] amount of \$24,602.22, alleged to be "deferred income not reported" of the partnership, Arthur Murray Dance Studio, for the fiscal year ended March 31, 1952.

D. Grant such other and further relief as the Court may deem proper.

Robert Ash, 1921 Eye Street, N. W., Washington 6,  
D. C., Attorney for Petitioner.

*Duly sworn to by Marzalia Schlade, jurat omitted in printing.*

## ATTACHMENT TO PETITION

U. S. Treasury Department  
Internal Revenue Service  
Regional Commissioner  
Omaha 2, Nebraska

In Replying Refer To:

RC:OMA(OMA):Ap  
WEF:BCR:bmb

Mrs. Marzalie Schlude  
459 Beverly Drive  
Omaha, Nebraska

Dear Mrs. Schlude:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1952, [fol. 19] discloses a deficiency in tax of \$8,971.55, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise, Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Assistant Regional Commissioner, Appellate, Room 100, Elks Club Building, 108 So. 18 Street, Omaha 2, Nebraska. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the defi-

ciency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

Russell C. Harrington, Commissioner, By Ray H. Johnson, Associate Chief Appellate.

Enclosures:

Statement  
IRS Pub 160 (Rev)  
Agreement Form

ORL-6-14-1

April 1957

57-2825 IRS-Omaha, Nebraska

[fol. 20]

ATTACHMENT

Statement

Marzalie Schlude  
459 Beverly Drive  
Omaha, Nebraska

Income Tax

Year

Deficiency

1952

\$8,971.55

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated July 3, 1956; to your protest received August 31, 1956; and to the statements made in the conferences held on November 20, 1956, and April 9, 1957.

A copy of this letter and statement has been mailed to your representative, Mr. Robert Ash, 1921 Eye Street, N. W., Washington 6, D. C., in accordance with the authority contained in the power of attorney executed by you.

## Taxable Year Ended December 31, 1952

## Schedule 1

## Adjustments to Net Income

Net income as disclosed by return	\$20,592.34
Additional income and unallowable deductions:	
(a) Partnership income	14,101.10
Corrected net income	\$34,693.44

## Schedule 2

## Explanation of Adjustments

(a) Examination of the books and records of the partnership of Arthur Murray Dance Studio discloses that your share of the distributable income for the taxable year ended March 31, 1952, is \$32,893.27. Inasmuch as you reported [fol. 21] \$18,792.17, your taxable income has been increased by the difference, \$14,101.10, computed as follows:

Ordinary net income on the partnership return \$ 37,584.33

Add:

Unallowable deductions and additional income

(1) Additional income	\$24,602.22
(2) Nonallowable deductions	3,600.00

Corrected partnership ordinary income \$ 65,786.55

Your distributable share \$ 32,893.27

As reported on Form 1040 18,792.17

Increase \$ 14,101.10

Explanation of partnership adjustments:

(1) Ordinary income is increased by the amount of \$24,602.22, computed as follows:

Deferred income not reported 3/31/52	\$131,143.92
"    "    "    "    "    3/31/51	106,541.70

Adjustment to income \$ 24,602.22



Your contention that the foregoing deferred income is not taxable in the taxable year ended March 31, 1952, is denied.

(2) Unallowable expenses of partnership:

Partnership expenses is reduced for personal use of automobile \$ 1,200.00

Personal expenses of partners included in partnership expenses 2,400.00

Total \$ 3,600.00

[fol. 22] Schedule 3

Computation of Tax

Net income, Schedule 1 \$ 34,093.44  
Less: Exemptions (1) 600.00

Income subject to tax \$ 34,093.44

Tax liability (tentative) \$ 17,439.54

Computation of Alternative Tax:

Income subject to tax \$ 34,093.44

Less: One-half excess of net long-term capital gain over net short-term loss 3,594.10

Balance \$ 30,499.34

Tax on \$30,499.34 \$ 15,010.56

Plus: 52% of \$3,594.10 1,868.93

Alternative tax \$ 16,879.49

Income tax liability \$ 16,879.49

Plus: Self-employment tax (as shown by return not changed) \$1.00

Total tax liability \$ 16,960.49

Tax liability shown by return, Orig. Acct. No.

AF 703636 7,988.94

Deficiency of income tax \$ 8,971.55

## IN THE TAX COURT OF THE UNITED STATES

ANSWER OF COMMISSIONER OF INTERNAL REVENUE  
IN DOCKET NO. 69592—Filed October 4, 1957

The Respondent, in answer to the petition filed in the above-entitled case, admits, denies and alleges as follows:

## I.

Admits the allegations of paragraph I of the petition.

[fol. 23]

## II.

Admits the allegations of paragraph II of the petition and alleges that the notice of deficiency was mailed to petitioner on July 2, 1957.

## III.

Admits the allegations of paragraph III of the petition.

## IV.

A., B. and C. Denies the allegations of error contained in subparagraphs A, B and C of paragraph IV of the petition.

## V.

A. and B. Admits the allegations of subparagraphs A and B of paragraph V of the petition.

C. to G., inclusive. Denies the allegations of subparagraphs C to G, inclusive, of paragraph V of the petition.

## VI.

Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the deficiency determined by the respondent be in all respects approved.

Nelson P. Rose, Chief Counsel, Internal Revenue Service.

Of Counsel, Douglas L. Barnes, Regional Counsel,  
Richard C. McLaughlin, Acting Special Assistant to the  
Regional Counsel, Internal Revenue Service, 100 Elks Club  
Building, Omaha, Nebraska.

[fol. 24]

IN THE TAX COURT OF THE UNITED STATES

Docket No. 69593

MARK F. SCHLUDE AND MARZALIE SCHLUDE,  
Husband and Wife, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION OF MARK F. SCHLUDE AND MARZALIE SCHLUDE  
IN DOCKET NO. 69593—Filed August 29, 1957

The above-named petitioners hereby petition for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (RC:OMA(OMA):Ap:WEF:BCR:bmb), dated July 2, 1957, and as a basis of their proceeding allege as follows:

I.

Petitioners are husband and wife whose address is 459 Beverly Drive, Omaha, Nebraska. The returns for the years here involved were filed with the District Director of Internal Revenue, Omaha, Nebraska.

II.

The notice of deficiency, a copy of which is attached hereto, and made a part of this petition by reference, is dated July 2, 1957.

III.

The taxes in controversy are income taxes for the years 1953 and 1954 in the total amount of \$94,949.14, the detail of which is as follows:

[fol. 25]

Year	Amount
1953	\$83,395.82
1954	11,544.32
Total	<u>\$94,940.14</u>

## IV.

The determination of tax set forth in said notice of deficiency is based upon the following errors:

A. The Commissioner erred in increasing petitioners' "partnership income" in the amount of \$108,398.41 for the year 1953.

B. The Commissioner erred in determining that petitioners' share of the distributable income of the partnership, Arthur Murray Dance Studio, for the taxable year ended March 31, 1953, is \$159,194.77.

C. The Commissioner erred in determining that petitioners' income should be increased by the amount of \$104,798.41, alleged to be "deferred income not reported" of the partnership, Arthur Murray Dance Studio, for the fiscal year ended March 31, 1953.

D. The Commissioner erred in increasing petitioners' "partnership income" in the amount of \$16,397.97 for the year 1954.

E. The Commissioner erred in determining that petitioners' share of the distributable income of the partnership, Arthur Murray Dance Studio, for the taxable year ended March 31, 1954, is \$85,491.10.

F. The Commissioner erred in determining that petitioners' income should be increased in the amount of \$12,797.97, alleged to be "deferred income not reported" of the partnership, Arthur Murray Dance Studio, for the fiscal year ended March 31, 1954.

## V.

The facts upon which the petitioners rely as the basis for this proceeding are:

[fol. 207.] A. On June 18, 1946, the petitioners formed a partnership for the purpose of conducting Arthur Murray Dance Studios in territories authorized by various franchise agreements received from Arthur Murray, Inc., New York, New York. By the year 1950 the petitioners had established dance studios in Omaha, Nebraska; Lincoln, Nebraska; and Sioux City, Iowa.

B. The partnership maintains its books of account on a fiscal year ending March 31 and uses the accrual method of accounting. The partners, petitioners herein, report their income on a calendar year basis.

C. During the fiscal year ended March 31, 1950, the partnership Arthur Murray Dance Studios contracted with students to give them a course of dance instruction. Some of the contracts extended beyond the end of the taxable year in which the contract was made.

D. Students paid the partnership either in cash or by check and deferred payments.

E. The partnership, using the accrual method of accounting, kept its books of account and reported the income it received from the dancing business when it was earned.

F. The method of accounting employed by the partnership clearly reflects its true income.

G. All items of gross income and deductions have been treated consistently since the commencement of the partnership business on June 18, 1946.

Wherefore, the petitioners pray that this Court may hear the proceeding and:

A. Determine that the Commissioner erred in increasing petitioners' "partnership income" in the amount of \$108,308.41 for the year 1953.

B. Determine that the Commissioner erred in determining that petitioners' share of the distributable income of the partnership, Arthur Murray Dance Studios, for the taxable year ended March 31, 1953, is \$159,194.77.

C. Determine that the Commissioner erred in determining that petitioners' income should be increased by the [fol. 27] amount of \$104,598.41, alleged to be "deferred income not reported" of the partnership, Arthur Murray Dance Studio, for the fiscal year ended March 31, 1953.

D. Determine that the Commissioner erred in increasing petitioners' "partnership income" in the amount of \$16,397.97 for the year 1954.

E. Determine that the Commissioner erred in determining that petitioners' share of the distributable income of the partnership, Arthur Murray Dance Studio, for the taxable year ended March 31, 1954, is \$85,491.10.

F. Determine that the Commissioner erred in determining that petitioners' income should be increased in the amount of \$12,797.97, alleged to be "deferred income not reported" of the partnership, Arthur Murray Dance Studio, for the fiscal year ended March 31, 1954.

G. Grant such other and further relief as the Court may deem proper.

Robert Ash, 1921 Eye Street, N. W., Washington 6,  
D. C., Attorney for Petitioners.

*Duly sworn to by Mark E. Schlude and Marzalia Schlude,  
jurat omitted in printing.*

[fol. 28]

## ATTACHMENT TO PETITION

U. S. Treasury Department  
Internal Revenue Service  
Regional Commissioner  
Omaha 2, Nebraska

Assistant Regional Commissioner, Appellate  
Room 100, Elks Club Building  
108 South 18th Street  
Omaha 2, Nebraska

Jul 2 1957

In Reply, Refer To:

RC (OM) (OM) Ap  
WEL BCR:bmb

Mr. Mark E. Schlude and  
Mrs. Marzalie Schlude,  
Husband and Wife  
459 Beverly Drive  
Omaha, Nebraska

Dear Mr. and Mrs. Schlude:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1953, and December 31, 1954, discloses deficiencies in tax aggregating \$94,940.14, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise, Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

[fol. 29] Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Assistant Regional Commissioner, Appellate Room 100, Elks Club Building, 408 So. 18 Street, Omaha 2, Nebraska. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 90 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

Russell C. Harrington, Commissioner, By Ray H. Johnson, Associate Chief Appellate.

Enclosures:

Statement  
IRS Pub 160 (Rev)  
Agreement Form

ORL-6-14-1  
April 1957

57-2825 IRS Omaha, Nebraska

ATTACHMENT

Statement

Mark E. Schlude and Marzalie Schlude,  
Husband and Wife  
459 Beverly Drive  
Omaha, Nebraska

Income Tax

Year	Deficiency
1953 .....	\$83,395.82
1954 .....	11,544.32
Total .....	\$94,940.14



[fol. 30] In making this determination of your income tax liability, careful consideration has been given to the report of examination dated July 3, 1956; to your protest received August 31, 1956; and to the statements made in the conferences held on November 20, 1956, and April 9, 1957.

A copy of this letter and statement has been mailed to your representative, Mr. Robert Ash, 1921 Eye Street, N. W., Washington 6, D. C., in accordance with the authority contained in the power of attorney executed by you.

### Taxable Year Ended December 31, 1953

#### Schedule 1

##### Adjustments to Net Income

Net income as disclosed by return		\$ 38,222.49
Additional income and unallowable deductions:		
(a) Partnership income	\$108,398.41	
(b) Unreported income	2,100.00	110,498.41
Corrected net income		\$168,720.90

#### Schedule 2

##### Explanation of Adjustments

(a) Examination of the books and records of the partnership of Arthur Murray Dance Studio discloses that your share of the distributable income for the taxable year ended March 31, 1953, is \$159,194.77. Inasmuch as you reported \$50,796.36, your taxable income has been increased by the difference, \$108,398.41, computed as follows:

[fol. 31]

Ordinary net income shown on partnership return ..... \$ 50,796.36

Add:

Unallowable deductions and additional income

(1) Additional income	\$104,798.41
(2) Nonallowable deductions	2,600.00

Corrected Arthur Murray Dance Studio partnership ordinary net income .....	\$159,194.77
Mark Schlude's distributive share .....	\$ 79,597.39
Marzalie Schlude's " " .....	79,597.38

Total .....	\$159,184.77
-------------	--------------

Arthur Murray Dance Studio partnership ordinary income reported on your return:

Mark E. Schlude .....	\$25,398.18	
Marzalie Schlude .....	25,398.18	50,796.36

Understatement .....	\$108,398.41
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Explanation of partnership adjustments:

- (1) Ordinary income is increased by the amount of \$104,798.41, computed as follows:

Deferred income not reported 3/31/53 .....	\$235,942.33
" " " " 3/31/52 .....	134,143.92

Adjustment to income .....	\$104,798.41
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Your contention that the foregoing deferred income is not taxable in the taxable year ended March 31, 1953, is denied.

- (2) Unallowable expense of partnership:

Partnership expense is reduced for personal use of automobile .....	\$ 1,200.00
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Personal expense of partners included in partnership expense .....	2,400.00
--	----------

Total .....	\$ 3,600.00
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[fol. 32] (b) It is held that you have unreported income of \$2,100.00; therefore, your taxable income is increased by this amount.

### Schedule 3

#### Computation of Tax

Net income, Schedule 1 .....	\$168,720.90
Less: Exemptions (2) .....	1,200.00
Income subject to tax .....	\$167,520.90

One-half of \$167,520.90 (joint computation)	\$ 83,760.45
Tax on \$83,760.45	\$56,112.38
Total tax ( $\$56,112.38 \times 2$ )	\$112,224.76
Computative of Alternative Tax (Joint Computation)	
One-half income, subject to tax	\$ 83,760.45
Less: One-half excess of net long-term capital gain over net short-term loss	4,034.35
Balance	\$ 79,726.10
Tax on \$79,726.10	\$52,688.86
Plus: 52% of \$4,034.35, net long-term capital gain	2,097.86
Tentative tax	\$54,786.52
Alternative tax (\$54,786.52 multiplied by 2)	\$109,573.04
Income tax liability	\$109,573.04
Plus: Self-employment tax (as shown by return—not changed)	162.00
Total tax liability	\$109,735.04
Tax liability shown by return, Orig. Acct. No. AF 1900221	26,339.22
Deficiency of income tax	\$ 83,395.82

[fol. 33]

Taxable Year Ended December 31, 1954

## Schedule 4

## Adjustments to Taxable Income

Taxable income as disclosed by return	\$ 68,284.97
Additional income and unallowable deductions:	
(a) Partnership income	\$16,397.97
(b) Depreciation adjustment	785.12
Corrected taxable income	\$ 85,468.06

## Schedule 5

## Explanation of Adjustments

(a) Examination of the books and records of the Arthur Murray Dance Studio discloses that your share of the distributable income for the taxable year ended March 31, 1954, is \$85,491.10. Inasmuch as you reported \$69,093.13, your taxable income has been increased by the difference, \$16,397.97, computed as follows:

Ordinary net income shown on partnership return .....	\$ 69,093.13
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Add:

(1) Additional income .....	12,797.97
(2) Nonallowable deduction .....	3,600.00

Corrected Arthur Murray Dance Studio partnership ordinary net income .....	\$ 85,491.10
--	--------------

Mark E. Schlude's distributive share .....	\$ 42,745.55
--	--------------

Marzalie Schlude's " .....	42,745.55
----------------------------	-----------

Total .....	\$ 85,491.10
-------------	--------------

Arthur Murray Dance Studio partnership ordinary income reported on your return:

Mark E. Schlude .....	\$34,546.57	
Marzalie Schlude .....	34,546.56	69,093.13

Understatement .....	\$ 16,397.97
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(fol. 34) Explanation of partnership adjustments:

(1) Ordinary income is increased by the amount of \$12,797.97, computed as follows:

Deferred income not reported 3/31/54 .....	\$248,740.30
" " " " 3/31/53 .....	235,942.33

Adjustment to income .....	\$ 12,797.97
----------------------------	--------------

Your contention that the foregoing deferred income is not taxable in the taxable year ended March 31, 1954, is denied.

(2) Unallowable expenses of partnership:

Partnership expense is reduced for personal expense of automobile .....	\$ 1,200.00
Personal expense of partners included in partnership expenses .....	2,400.00
Total .....	\$ 3,600.00

(b) The sum of the years-digits method of computing depreciation is not applicable to property constructed prior to 1954. Therefore, the depreciation allowable on your building has been recomputed using the straight-line method as follows:

Item	Date Acquired	Cost	Life	Depreciation Allowable
Building .....	10-1-54	\$97,704.80	✓ 40 years	\$610.66 (14 yr.)
Depreciation allowable .....				\$ 610.66
Claimed on return .....				1,395.78
Amount not allowable .....				\$ 785.12

[fol. 35]

Schedule 6

Computation of Tax

Taxable income, Schedule 4 .....	\$ 85,468.06
One-half of \$85,468.06 .....	\$ 42,734.03
Tax on \$42,734.03 .....	\$21,626.48
Total tax (\$21,626.48 × 2) .....	\$ 43,252.96

Computation of Alternative Tax (Joint Computation)

One-half taxable income .....	\$ 42,734.03
Less: One-half excess of net long-term gain over net short-term loss .....	42.66
Balance .....	\$ 42,691.37

Tax on \$42,691.37 .....	\$21,597.05
Plus: 50% of \$42.66, net long- term capital gain .....	21.33
<hr/> Tentative tax .....	<hr/> \$21,618.38
Alternative tax (\$21,618.38 multiplied by 2) .....	\$ 43,236.76
Income tax liability .....	\$ 43,236.76
Plus: Self-employment tax (as shown by re- turn—not changed) .....	216.00
<hr/> Total tax liability .....	<hr/> \$ 43,452.76
Tax liability shown by return, Orig. Acct. No. AC 1000048 .....	31,908.44
<hr/> Deficiency of income tax .....	<hr/> \$ 11,544.32

# IN THE TAX COURT OF THE UNITED STATES

## ANSWER OF COMMISSIONER OF INTERNAL REVENUE IN DOCKET No. 69,93—Filed October 4, 1957

The Respondent, in answer to the petition filed in the above-entitled case, admits, denies and alleges as follows:

[fol. 36]

I.

Admits the allegations of paragraph I of the petition.

II.

Admits the allegations of paragraph II of the petition and alleges that the notice of deficiency was mailed to petitioners on July 2, 1957.

III.

Admits the allegations of paragraph III of the petition.

IV.

A. to F., inclusive. Denies the allegations of error contained in subparagraphs A to F, inclusive, of paragraph IV of the petition.

## V.

A. and B. Admits the allegations of subparagraphs A and B of paragraph V of the petition.

C. to G., inclusive. Denies the allegations of subparagraphs C to G, inclusive, of paragraph V of the petition.

## VI.

Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the deficiencies determined by the respondent be in all respects approved.

Nelson P. Rose, Chief Counsel, Internal Revenue Service.

Of Counsel, Douglas L. Barnes, Regional Counsel, Richard C. McLaughlin, Acting Special Assistant to the Regional Counsel, Internal Revenue Service, 100 Elks Club Building, Omaha, Nebraska.

[fol. 37]

## IN THE TAX COURT OF THE UNITED STATES

Docket No. 62109

MARK E. SCHLUDE and MARZALIE SCHLUDE, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 69594

MARK E. SCHLUDE, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 69592

MARZALIE SCHLUDE, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 69593

MARK E. SCHLUDE and MARZALIE SCHLUDE, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

STIPULATION OF FACTS IN DOCKET NOS. 62109, 69591,  
69592 AND 69593—Filed March 24, 1958

It is hereby stipulated that, for the purpose of these cases, the following statements may be accepted as facts



and all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part hereof, [fol. 38] subject to the right of either party to object to the admission of such facts or exhibits in evidence on the grounds of materiality and relevancy; provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. Petitioners are husband and wife and now reside at 459 Beverly Drive, Omaha, Nebraska. The returns for the years here involved were filed with the office of the now District Director of Internal Revenue (formerly Collector or Director of Internal Revenue) for the District of Nebraska.

2. On June 18, 1946, the petitioners formed a partnership for the purpose of conducting Arthur Murray Dance Studios in territories authorized by various franchise agreements received from Arthur Murray, Inc., New York, New York. The location of the various studios being operated and the date of their formation is as follows:

Location	Date of Formation
Omaha, Nebraska .....	June 18, 1946
Lincoln, Nebraska .....	September 20, 1948
Sioux City, Iowa .....	October 1, 1949
Sioux Falls, South Dakota .....	June 1, 1952
Grand Island, Nebraska .....	October 3, 1953

3. The partnership maintains its books of account on fiscal years ending March 31st and uses the accrual method of accounting. The partners, petitioners herein, report their income on a calendar year basis and use the cash basis of accounting.

4. Attached hereto are photostatic copies of U. S. Partnership Return of Income for the taxable years ending March 31, 1949 to March 31, 1954, inclusive, which are marked Exhibits 1-A to 6-F, inclusive.

5. Attached hereto are photostatic copies of petitioners' United States Individual Income Tax Returns, which are marked as follows:

[fol. 39] Mark E. Schlude and Marzalie

Schlude—1950 .....	Exhibit 7-G
Mark E. Schlude—1951 .....	Exhibit 8-H
Marzalie Schlude—1951 .....	Exhibit 9-I
Mark E. Schlude—1952 .....	Exhibit 10-J
Marzalie Schlude—1952 .....	Exhibit 11-K
Mark E. and Marzalie Schlude —1953 .....	Exhibit 12-L
Mark E. and Marzalie Schlude —1954 .....	Exhibit 13-M

6. Attached hereto and marked Exhibit 14-N is a schedule entitled "Schedule Reflecting Contract Amount of Deferred Income and Amount of Deferred Income Collected and Uncollected at End of Each Fiscal Year." This schedule shows for the fiscal years ended March 31, 1950 to March 31, 1954, inclusive, Contract Amount of Deferred Income, Students Accounts Receivable, Reserve Fund Held by Bank, Deferred Income Collected (considering reserve fund held by bank as collected) and Deferred Income Collected (considering reserve fund held by bank as not collected until funds are released and made available for withdrawal by bank).

7. Petitioners are equal partners in the partnership known as Arthur Murray Dance Studio.

8. When a student engaged the studio to teach dancing lessons, the student and the studio executed one of the six forms of contracts attached hereto and marked Exhibits 15-O to 20-T.

9. If the contract executed was on a form entitled "Deferred Payment Enrollment Agreement and Contract With Student for Instruction", attached hereto and marked Exhibit 18-R, or on a form entitled "Deferred Payment Extension Agreement and Contract With Student for Instruction" attached hereto and marked Exhibit 19-S, or on a form entitled "Deferred Payment Renewal Agreement and Contract with Student for Instruction", marked Exhibit 20-T, then the student also executed, at the time of signing the contract, a note on a form such as is attached hereto and marked Exhibit 21-U.

[fol. 40] 10. At the time a student's note, referred to in paragraph 9 above, was transferred to the bank, the bank would deduct its interest charges and give approximately 50% of the balance of the note to the partnership and set up a reserve account for the other 50% of the note which the partnership could not use. After the note was paid in full by the student, the balance in the reserve account was transferred to the partnership's general bank account.

11. Cash payments received by the partnership directly from students, the amounts received by the partnership at the time notes were transferred to the bank and the amounts received by the partnership when notes transferred to the bank were fully paid, were either deposited or credited to a partnership general bank account without segregation from other partnership funds.

12. Income as reflected in the partnership books and returns for the fiscal years ended March 31, 1950 through March 31, 1954, included gains on cancellations of students' contracts as follows:

3-31-50	3-31-51	3-31-52	3-31-53	3-31-54
\$5,376.93	\$9,997.44	\$26,861.40	\$19,483.36	\$28,448.61

13. Unpaid balances on notes held by bank for the fiscal years ended March 31, 1950 through March 31, 1954, were as follows:

	3-31-50	3-31-51	3-31-52	3-31-53	3-31-54
Ending Balance	\$13,783.78	\$1,842.10	\$9,618.00	\$40,627.96	\$23,410.75
Beginning Balance	17,237.71	13,783.78	1,842.10	9,618.00	40,627.96

Robert Ash, Counsel for Petitioners.

Arch M. Cantrall, Chief Counsel, Internal Revenue Service, Counsel for Respondent.

FORM 1066  
Treasury Department  
Internal Revenue Service

# UNITED STATES PARTNERSHIP RETURN OF INCOME

## 1948

(To be Filed Also by Syndicates, Pools, Joint Ventures, Etc.)

For Calendar Year 1948

or fiscal year beginning ..... 1948, and ending ..... 1949

(File this return with the Collector of Internal Revenue not later than the 15th day of the 3d month following the close of the taxable year)

(PRINT PLAINLY NAME AND BUSINESS ADDRESS OF THE ORGANIZATION)

Arthur Murray Dance Studio

309 South 19th Street

Omaha

Douglas

Nebraska

(City, town, or post office)

(Postal zone number)

(State)

Business or Profession

Instruction of Ballroom

Do Not Use These Spaces

File No.

Serial No. 8851301

District

(Date Received)

18 1948

DIST. NEBR.

Item and  
Instruction No.

## GROSS INCOME

1. Gross receipts from business or profession		115,605	00
2. Less cost of goods sold:			
(a) Inventory at beginning of year	\$		
(b) Merchandise bought for sale			
(c) Cost of labor, supplies, etc.			
(d) Total of lines (a), (b), and (c)	\$		
(e) Less inventory at end of year			
3. Gross profit (or loss) from business or profession (item 1 less item 2)		115,605	00
4. Income (or loss) from other partnerships, syndicates, pools, etc. (State separately name, address, and amount)			
5. Interest on bank deposits, notes, corporation bonds, etc. (except interest to be reported in item 6)		580	83
6. Interest on tax-free covenant bonds upon which a Federal tax was paid at source			
7. Interest on Government obligations, etc., unless wholly exempt from tax			
8. Rents			
9. Royalties			
10. Net gain (or loss) from sale or exchange of property other than capital assets (from line 2, Schedule A)			
11. Dividends			
12. Other income (state nature of income)			
13. Total income in items 3 to 12		114,284	83

## DEDUCTIONS

14. Salaries and wages (do not include compensation for partners)		52,402	51
15. Rent		5,350	51
16. Repairs		224	00
17. Interest on indebtedness (explain in Schedule E; do not include interest on capital invested in the business by any partner)		75	00
18. Taxes (explain in Schedule E)			
19. Losses by fire, storm, shipwreck, or other casualty, or theft (submit schedule)			
20. Bad debts (explain in Schedule C)		117	00
21. Depreciation (explain in Schedule D)		2,733	00
22. Amortization of emergency facilities (attach statement)			
23. Depletion of mines, oil and gas wells, timber, etc. (submit schedule)			
24. Other deductions authorized by law (explain in Schedule E)		37,830	00
25. Total deductions in items 14 to 24		68,394	02
26. Ordinary net income (item 13 less item 25)		45,890	81
27. Net short-term capital gain (or loss) (from line 4, Schedule C)		-	-
28. Net long-term capital gain (or loss) (from line 8, Schedule C)		-	-





## Other Deductions—Line 24—Page 1:

Arthur Murray Dance Studio—Omaha &  
Lincoln, Nebraska.

For Year Ended March 31, 1949.

Supplies for instructors .....	\$ 141.55
Tuition cost paid other Arthur Murray Dance Studios .....	418.50
Royalties to Arthur Murray .....	10,676.66
Advertising expense .....	9,664.72
Automobile expense .....	573.31
Dues and subscriptions .....	98.50
Insurance expense .....	316.58
Professional services .....	2,258.70
Miscellaneous expense .....	1,571.22
Personal property tax expense .....	144.18
Payroll tax expense .....	1,299.85
Janitor service .....	1,200.00
Redecorating expense .....	739.00
Office stationery & supplies .....	1,453.93
Telephone and telegraph .....	1,626.91
Records .....	800.19
Heat, light and water .....	1,108.73
Club Dues and entertainment .....	1,858.74
Travel and convention expense .....	1,275.00
Cost of removing partitions and fixtures to new location .....	200.00
Loss on equipment disposed of .....	203.99
Total .....	<u><u>\$37,630.26</u></u>



# Schedule H.—BALANCE SHEETS

ASSETS	Beginning of taxable year		End of taxable year	
	Amount	Total	Amount	Total
1. Cash		10,989 97		3,822 18
2. Notes and accounts receivable (less reserve)		4,785 00		8,007 13
3. Inventories				
4. Investments				
5. Depreciable assets	\$ 11,654 81		\$ 19,280 96	
Less: Reserve for depreciation	3,503 66	8,161 15	7,428 52	11,852 44
6. Land		1,102 11		290 23
7. Other assets		6,306 51		25,101 60
8. Total assets		\$ 31,334 74		\$ 54,074 84
LIABILITIES	Beginning of taxable year		End of taxable year	
	Amount	Total	Amount	Total
9. Accounts payable		\$ 1,647 28		\$ 1,502 23
10. Notes and mortgages payable		1,028 02		36 00
11. Accrued expenses		1,165 51		1,558 09
12. Other liabilities - Deferred		32,899 81		35,204 04
13. Partners' capital accounts:				
(a)				
(b) Mark E. Schlude	( 2,702 94 )		( 7,887 24 )	
(c)				
(d) Margalite Schlude	( 2,702 94 )		( 7,887 24 )	
(e)				
(f)		( 5,405 88 )		15,774 48
14. Total liabilities		\$ 31,334 74		\$ 54,074 84

## Schedule I.—PARTNERS' SHARES OF INCOME AND CREDITS. (See Instruction for Schedule I)

1. Name and address of each partner (Designate correspondent address, if any) Where return of partner or member is filed in another collection district, specify district	2. Percentage of time devoted to business	3. Ordinary net income (Item 28, page 1) less any partially tax-exempt interest included in item 7, page 1	4. Partially tax-exempt interest included in item 7, page 1
(a)			
(b) Mark E. Schlude Omaha	100%	16,845 44	
(c)			
(d) Margalite Schlude Omaha	100%	16,845 45	
(e)			
(f)			
Total		\$ 33,690 89	

## CONTINUATION OF SCHEDULE I

1. Net short-term gain (or loss) from sale or exchange of capital assets (from item 28, page 1)	2. Net long-term gain (or loss) from sale or exchange of capital assets (from item 28, page 1)	3. Charitable contributions (from Schedule F)	4. Federal income tax paid at source (2 percent of item 3, page 1)	5. Income and profits taxes paid to a foreign country or United States possession
(a)				
(b)		21 40		
(c)				
(d)		21 40		
(e)				
(f)				
Total		\$ 42 80		

## AFFIDAVIT (See Instruction D)

I swear (or affirm) that this return (including any accompanying schedules and statements) has been examined by me, and to the best of my knowledge and belief is a true, correct, and complete return.

*Philip J. Harris*  
(Signature of person (other than partner or member) preparing return)

2/15/49  
(Date)

*Margalite Schlude*  
(Signature of partner or member)

2/15/49  
(Date)

(Name of firm or employer, if any)

Subscribed and sworn to before me this

15<sup>th</sup> day of Jan, 1949

*Clayton B. ...*  
(Signature of officer administering oath)

(Title)

U. S. GOVERNMENT PRINTING OFFICE 16-5854-1

(Address of partner or member)

Subscribed and sworn to before me this

15<sup>th</sup> day of Jan, 1949

*Clayton B. ...*  
(Signature of officer administering oath)

(Title)



# PARTNERSHIP RETURN OF INCOME

Page 1  
1949

(To Be Filed Also by Syndicates, Pools, Joint Ventures, Etc.)

For Calendar Year 1949

or fiscal year beginning April 1, 1949, and ending March 31, 1950

(File this return with the Collector of Internal Revenue not later than the 15th day of the 3d month following the close of the taxable year)

(PRINT PLAINLY NAME AND BUSINESS ADDRESS OF THE ORGANIZATION)

ARTHUR MURRAY DANCE STUDIO

(Name)

309 SOUTH 19th STREET

(Street and number)

OMAHA

(City, town, or post office)

DOUGLAS

(Postal zone number)

NEBRASKA

(State)

Business or Profession Instruction of Ballroom Dancing

File No.  
Serial No. 8851544  
Date Recd.

GROSS INCOME		
1. Gross receipts from business or profession		\$ 125,599 44
2. Less cost of goods sold:		
(a) Inventory at beginning of year	\$	
(b) Merchandise bought for sale		
(c) Cost of labor, supplies, etc.		
(d) Total of lines (a), (b), and (c)	\$	
(e) Less inventory at end of year		
3. Gross profit (or loss) from business or profession (item 1 less item 2)		\$ 125,599 44
4. Income (or loss) from other partnerships, syndicates, pools, etc. (State separately name, address, and amount)		
5. Interest on bank deposits, notes, corporation bonds, etc. (except interest to be reported in item 6)		760 90
6. Interest on tax-free covenant bonds upon which a Federal tax was paid at source		
7. Interest on Government obligations, etc., unless wholly exempt from tax		
8. Dividends		
9. Royalties		
10. Net gain (or loss) from sale or exchange of property other than capital assets (From line 2, Schedule A)		
11. Pensions		
12. Other income (state nature of income)		
13. Total income in items 3 to 12		\$ 126,360 34
DEDUCTIONS		
14. Salaries and wages (do not include compensation for partners)	\$	42,722 34
15. Rent		8,065 30
16. Interest on indebtedness (explain in Schedule E; do not include interest on capital invested in the business by any partner)		9 00
17. Taxes (explain in Schedule B)		1,870 42
18. Losses by fire, storm, shipwreck, or other casualty, or theft		
19. Bad debts (explain in Schedule C) <b>Cash Advances to employees</b>		407 37
20. Depreciation (explain in Schedule D)		5,239 96
21. Repairs		617 54
22. Amortization of emergency facilities (attach statement)		
23. Depletion of mines, oil and gas wells, timber, etc. (attach schedule)		
24. Other deductions authorized by law (explain in Schedule E)		47,611 97
25. Total deductions in items 14 to 24		106,543 90
26. Ordinary net income (item 13 less item 25)		\$ 19,816 44
27. Net short term capital gain (or loss) (from line 4, Schedule G)		\$ 554 42
28. Net long term capital gain (or loss) (from line 8, Schedule G)		\$

EXHIBIT 2-B

EXHIBIT 2-B SUPPLEMENT OF FACTS

104

**Schedule A.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY OTHER THAN CAPITAL ASSETS.**  
(See Instruction 10)

1. Kind of property	2. Date acquired <i>Mo. Day Year</i>	3. Date sold <i>Mo. Day Year</i>	4. Gross sales price (contract price)	5. Depreciation allowed (or allow- able) since acqui- sition or March 1, 1913 (emphasis in Schedule D)	6. Cost or other basis and cost of subse- quent improvements (if not purchased, attach explanation)	7. Expenses of sale
			\$	\$	\$	\$
1. Totals			\$	\$	\$	\$
2. Total net gain or loss (columns 4 plus 5 minus the sum of columns 6 and 7). Enter as item 10, page 1						\$

**Schedule B.—TAXES.** (See Instruction 17)

Nature	Amount	Nature (continued)	Amount (continued)
Payroll Taxes	1,737 57		
Personal Property Taxes	132 85		
	<u>1,870 42</u>		
		Total (enter as item 18, page 1)	

## Schedule C.—BAD DEBTS. (See Instruction 19)

1. Taxable year	2. Net income reported		3. Sales on account		4. Bad debts of organization if no reserve is carried on books	5. If organization carried a reserve—	
						5. Gross amount added to reserve	6. Amount charged against reserve
1946	\$		\$		\$		
1947							
1948							
1949							

NOTE—Check whether deduction claimed represents debts which have become worthless ☐ or is an addition to a reserve ☐.

**Schedule D.—DEPRECIATION.** (See Instruction 20)

1. Kind of property (if buildings, state material of which constructed)	2. Date acquired	3. Cost or other basis (do not include land or other nondepreciable property)	4. Assets fully depreciated in use at end of year	5. Depreciation allowed (or allowable) in prior years	6. Remaining cost or other basis to be recovered	7. Estimated life used in accumulating depreciation	8. Estimated remaining life from beginning of year	9. Depreciation allowable this year
Music Equipment	Various	1,910 67	\$	\$ 809 25	1,101 42	2 yrs		\$ 548 46
Automobile		5,989 40		1,115 10	4,874 30	3 yrs		1,473 16
Furniture & Fixtures		12,349 40		2,672 29	9,677 11	5 yrs		2,257 87
Leasehold Improvements		4,011 52		2,831 88	1,179 64	Period of Leases	of	960 47
Total (enter as item 21, page 1) (* See Attached schedule)								
								\$5,239 96

**Schedule E.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 16 AND 24**

1. Item No.	2. Explanation	3. Amount
16	Interest on discount paper defaulted by maker	\$9.00

**Schedule F.—CONTRIBUTIONS OR GIFTS PAID.** (See instruction for Schedule I)

Name and address of organization	Amount	Name and address of organization (continued)	Amount (continued)
The Disabled American Vet	\$ 5 00		\$
Omaha Community Chest	25 00		
Nebraska T. B. A'ssn.	5 00		
March of Dimes	10 00		
Nebraska Society for crippled children	4 00		
		Total (enter in column 7, Schedule I)	\$ 49 00

[fol. 45]

Other Deductions—Line 24—Page 1.  
Arthur Murray Dance Studio—Omaha,  
Lincoln and Sioux City.

For the Year Ended March 31, 1950.

Description	Amount
Royalties to Arthur Murray .....	\$14,108.70
Advertising .....	11,839.66
Records .....	1,139.08
Instructors supplies.....	168.16
Office stationery and supplies.....	1,765.93
Insurance .....	414.88
Maintenance .....	1,200.00
Heat, light and power.....	1,168.58
Telephone and telegraph.....	2,439.36
Professional services.....	2,621.00
Automobile expense.....	617.33
Travel and convention costs.....	2,295.90
Club dues and entertainment.....	1,523.09
Contests, party and ball entertainment for the students .....	797.46
Dues and subscriptions.....	152.18
Miscellaneous .....	2,140.15
Tuition paid other schools.....	592.00
Cost of training instructors.....	1,204.72
Cost of aid received from Denver, Colorado, Arthur Murray Dance Studio.....	1,240.59
Loss on special class courses.....	185.00
	<u>\$47,611.97</u>

Schedule of Depreciation—Automobiles.

Description	Cost	Depreciation		Depreciation
		Allowed Prior Years	Remaining Cost	Allowable This Year
Cadillac* ...	\$4,014.40	\$1,115.10	\$2,899.30	\$1,253.72
Ford .....	1,975.00	-0-	1,975.00	219.44
	<u>\$5,989.40</u>	<u>\$1,115.10</u>	<u>\$4,874.30</u>	<u>\$1,473.16</u>

\* Note—Auto sold November 1949.



## Schedule G.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS. (See instructions 27-28)

1. Kind of property (if necessary, attach statement of descriptive details not shown below)	2. Date acquired Mo. Day Year	3. Date sold Mo. Day Year	4. Gross sales price (net of cost)	5. Depreciation allowed (or allowable) since acquisition or March 1, 1913 (explain in Schedule D)	6. Cost or other basis and cost of subsequent improvements (if not purchased, attach explanation)	7. Expenses of sale
<b>SHORT-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD NOT MORE THAN 6 MONTHS</b>						
			\$	\$	\$	\$
1. Totals			\$	\$	\$	\$
2. Net short-term gain or loss other than from other partnerships and from common trust funds (column 4 plus column 5 minus the sum of columns 6 and 7, of line 1)						
3. Enter share of net short-term gain or loss from other partnerships and from common trust funds						
4. Enter here and also as item 27, page 1, the sum of gains or losses, or difference between gain and loss, shown in lines 2 and 3						

<b>LONG-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR MORE THAN 6 MONTHS</b>						
Automobile	6/48	3/8/50	\$ 2,200 00	\$ 2,368 82	\$ 4,014 40	\$ -0-
5. Totals			\$ 2,200 00	\$ 2,368 82	\$ 4,014 40	\$ -0-
6. Net long-term gain or loss other than from other partnerships and from common trust funds (column 4 plus column 5 minus the sum of columns 6 and 7, of line 5)						
7. Enter the full amount of share of net long-term gain or loss from other partnerships and from common trust funds						
8. Enter here and also as item 28, page 1, the sum of gains or losses, or difference between gain and loss, shown in lines 6 and 7						

## QUESTIONS

- Date of organization June 18, 1946
- If this is the organization's first return, indicate whether (a) completely new business ☐, or (b) successor to previously existing business, which was organized as (1) corporation ☐, (2) partnership ☐, or (3) sole proprietorship ☐, or (4) other (indicate)    
If successor to previously existing business, give name and address of the previous business organization
- Nature of organization (partnership, syndicate, pool, joint venture, etc.) Partnership
- Was a return of income filed for preceding year? yes If so, to which collector's office was it sent? Omaha
- Check whether this return was prepared on the cash ☐ or accrual ☒ basis.
- State whether inventories at the beginning and end of the taxable year were valued at (a) cost, or (b) cost or market whichever is lower    
If any other basis is used, attach statement describing basis fully, state why used and the date inventory was last reconciled with stock
- Is any member of the partnership the spouse, son, or daughter of any other member? (Answer "Yes" or "No") Yes
- Did the organization at any time during the taxable year own directly or indirectly any stock of a foreign corporation or of a personal holding company, as defined in section 501 of the Internal Revenue Code? (Answer "Yes" or "No") NO If answer is "Yes," attach list showing name and address of each such corporation and amount of stockholdings.
- Was return of information on Forms 1096 and 1099, or Form W-2a, filed for the calendar year 1949? Yes (See Instruction H.)

## Schedule H - BALANCE SHEETS

ASSETS	Beginning of fiscal year		End of fiscal year	
	Amount	Total	Amount	Total
1. Cash		\$ 8,822 78		\$ 21,926 96
2. Notes and accounts receivable (less reserve)		8,007 79		19,099 17
3. Inventories				
4. Investments				
5. Depreciable assets	\$ 19,280 96		\$ 20,246 59	
Less: Reserve for depreciation	7,428 52	11,852 44	10,299 66	9,946 93
6. <del>Land</del> Deferred Charges		290 23		337 39
7. Other assets		25,101 60		32,739 79
8. Total assets		\$ 54,074 84		\$ 84,050 24
LIABILITIES	Beginning of fiscal year		End of fiscal year	
	Amount	Total	Amount	Total
9. Accounts payable		\$ 1,502 23		\$ 575 90
10. Notes and mortgages payable		36 00		
11. Accrued expenses		1,558 09		3,463 03
12. <del>Schedule H</del> Deferred Income		35,204 04		61,711 87
13. Partners' capital accounts:				
(a)				
(b) Mark E. Schlude	\$ 7,887 24		8,984 55	
(c)				
(d) Marzelle Schlude	7,887 24		9,314 89	
(e)				
(f)		15,774 48		18,299 44
14. Total liabilities		\$ 54,074 84		\$ 84,050 24

## Schedule I.—PARTNERS' SHARES OF INCOME AND CREDITS. (See Instruction for Schedule I)

1. Name and address of each partner (Designate permanent home, if any) Where return of partner or member is filed in another collection district, specify district	2. Percentage of time devoted to business	3. Ordinary net income (item 28, page 1) less any partially tax-exempt interest included on item 7, page 1	4. Partially tax-exempt interest included on item 7, page 1
(a)			
(b) Mark E. Schlude - Omaha	100%	9,908 22	
(c)			
(d) Marzelle Schlude - Omaha	100%	9,908 22	
(e)			
(f)			
Total		\$ 19,816 44	

## CONTINUATION OF SCHEDULE I

1. Net short-term gain (or loss) from sale or exchange of capital assets (from item 28, page 1)	2. Net long-term gain (or loss) from sale or exchange of capital assets (from item 28, page 1)	3. Charitable contributions (from Schedule F)	4. Federal income tax paid at source (2 percent of item 3, page 1)	5. Income and profits taxes paid to a foreign country or United States possession
(a)				
(b)	277 21	24 50		
(c)				
(d)	277 21	24 50		
(e)				
(f)				
Total	\$ 554 42	\$ 49 00		

## DECLARATION (See Instruction D)

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me, and to the best of my knowledge and belief is a true, correct, and complete return.

*J. Albert J. R. sum*  
 (Signature of person (other than partner or member) preparing return)

7/3/50  
 (Date)

*Mark E. Schlude* 7/3/50  
 (Partner or member) (Date)

(Name of firm or employee, if any)

120 N. 36th St. Apt 11  
 (Address of partner or member)

# PARTNERSHIP RETURN OF INCOME

1950

(To Be Filed Also by Syndicates, Pools, Joint Ventures, Etc.)  
For Calendar Year 1950 or other taxable years ending  
after Sept. 30, 1950, but before Dec. 31, 1951  
or fiscal year beginning April 1, 1950, and ending March 31, 1951

(File this return with the Collector of Internal Revenue not later than the 15th day of  
the 1st month following the close of the taxable year)

(PRINT PLAINLY NAME AND BUSINESS ADDRESS OF THE ORGANIZATION)

ARTHUR MURRAY DANCE STUDIO

(Name)

309 South 19th Street

(Street and number)

OMAHA

(City, town or post office)

NEBRASKA

(Postal zone number)

(State)

Principal business activity (see Instruction J) Instruction of Ballroom Dancing

Do Not Use These Spaces

File Code

Serial No.

District

(Date Reserved)

Item and  
Instruction No.

## GROSS INCOME

147,589 15

1. Gross receipts from business or profession

2. Less cost of goods sold

(a) Inventory at beginning of year

(b) Merchandise bought for sale

(c) Cost of labor, supplies, etc.

(d) Total of lines (a), (b), and (c)

(e) Less inventory at end of year

147,589 15

3. Gross profit (or loss) from business or profession (item 1 less item 2)

4. Income (or loss) from other partnerships, syndicates, pools, etc. (State separately name, address and amount)

5. Interest on bank deposits, notes, corporation bonds, etc. (except interest to be reported in item 6)

882 69

6. Interest on tax-free covenant bonds upon which a Federal tax was paid at source

7. Interest on Government obligations, etc., unless wholly exempt from tax

8. Rents

9. Royalties

10. Net gain (or loss) from sale or exchange of property other than capital assets (from line 2, Schedule A)

11. Dividends

12. Other income (state nature of income)

Cash Overage

91 32

13. Total income in items 3 to 12

148,563 16

## DEDUCTIONS

14. Salaries and wages (do not include compensation for partners)

15. Rent

16. Interest on indebtedness (explain in Schedule E; do not include interest on capital invested in the business by any partner)

17. Taxes (explain in Schedule B)

18. Losses by fire, storm, shipwreck, or other casualty, or theft (attach schedule)

19. Bad debts (explain in Schedule C)

Employees Cash Advances

20. Depreciation (explain in Schedule D)

21. Repairs

22. Amortization of emergency facilities (attach statement)

23. Depletion of mines, oil and gas wells, timber, etc. (attach schedule)

24. Other deductions authorized by law (explain in Schedule E)

25. Total deductions in items 14 to 24

26. Ordinary net income (item 13 less item 25)

50,302 82

9,990 07

2,294 97

35 00

4,761 77

884 51

55,082 17

123,351 31

25,211 86

27. Net short-term capital gain (or loss) (from line 4, Schedule G)

28. Net long-term capital gain (or loss) (from line 5, Schedule G)

EXHIBIT 3-C

EXHIBIT 3-C TO STATEMENT OF FACTS



**Schedule A.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY OTHER THAN CAPITAL ASSETS**  
(See instruction 10)

1 Kind of property	2 Date acquired Mo Day Year	3 Date sold Mo Day Year	4 Gross sales price (contract price)	5 Depreciation allowed (or allow- able) since acqui- sition or March 1 1913 (explain in Schedule D)	6 Cost or other basis and cost of substi- tute improvements (if not purchased attach explanation)	7 Expense of sale
			\$	\$	\$	\$
Totals			\$	\$	\$	\$
Total net gain or loss (columns 4 plus 5 minus the sum of columns 6 and 7). Enter as item 10, page 1.						

## Schedule B.—TAXES. (See Instruction 17.)

Nature	Amount	Nature (continued)	Amount (continued)
Payroll taxes	1,895 25		
Personal property taxes	399 72		
		Total (enter as item 17, page 1)	2,294 97

**Schedule C.—BAD DEBTS.** (See Instruction 19)

1. Taxable year	2. Net income reported	3. Sales on account	4. Bad debts of organization if no reserve is carried on books	If organization carried a reserve	
				5. Gross amount added to reserve	6. Amount charged against reserve
1947	\$	\$	\$	\$	\$
1948					
1949					
1950					

NOTE.—Check whether deduction claimed represents debts which have become worthless [ ], or is an addition to a reserve [ ]

**Schedule D.—DEPRECIATION.** (See Instruction 20)[illegible]

## Schedule E.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 16 AND 24

Item No.	2. Explanation	3. Amount	1. Item No. (continued)	2. Explanation (cont. record)	3. Amount (cont. record)

## Schedule F.—CONTRIBUTIONS OR GIFTS PAID. (See instruction for Schedule J)

Name and address of organization	Amount	Name and address of organization (continued)	Amount
American Red Cross	55 00	Knights of Columbus	10 00
Nebr. Div. of Cancer Society	10 00	Nebr. T. B. ASSOC.	5 00
Veterans of Foreign Wars	10 00	Goodfellows Charities	50 00
Disabled American Vets	10 00	Nebr. Society for Crippled Children	20 00
Sister E. Kenning	10 00	March of Dimes	10 00
Omaha Community Chest	25 00		
Kiwanis Club of Dundee	10 00		
		Total (enter in column 2, Schedule J)	225 00

## Schedule G.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS. (See instructions 27-28)

Kind of property (if necessary, attach statement of descriptive details not shown below)	2. Date acquired	3. Date sold	4. Gross sales price (net of cost)	5. Depreciation allowed (or allowable) since acquisition or March 1, 1913 (unless on Schedule D)	6. Cost or other basis and cost of subsequent improvements (if not purchased, attach explanation)	7. Expenses of sale
	Mo. Day Year	Mo. Day Year				

## SHORT-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD NOT MORE THAN 6 MONTHS

	\$	\$	\$	\$	\$	\$
1 Totals	\$	\$	\$	\$	\$	\$
2 Net short-term gain or loss other than from other partnerships and from common trust funds (column 4 plus column 5 minus the sum of columns 6 and 7, of line 1)						\$
3 Enter share of net short-term gain or loss from other partnerships and from common trust funds						\$
4 Enter here and also as item 27, page 1, the sum of gains or losses, or difference between gain and loss, shown in lines 2 and 3						\$

## LONG-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR MORE THAN 6 MONTHS

	\$	\$	\$	\$	\$	\$
5 Totals	\$	\$	\$	\$	\$	\$
6 Net long-term gain or loss other than from other partnerships and from common trust funds (column 4 plus column 5 minus the sum of columns 6 and 7, of line 5)						\$
7 Enter the full amount of share of net long-term gain or loss from other partnerships and from common trust funds						\$
8 Enter here and also as item 28, page 1, the sum of gains or losses, or difference between gain and loss, shown in lines 6 and 7						\$

## QUESTIONS

- 1 Date of organization **June 18, 1946**
- 2 If this is the organization's first return, indicate whether (a) completely new business ☐ or (b) successor to previously existing business, which was organized as (1) corporation ☐, (2) partnership ☐, or (3) sole proprietorship ☐, or (4) other (indicate)
- If successor to previously existing business, give name and address of the previous business organization
- 3 Nature of organization (partnership, syndicate, pool, joint venture, etc.) **Partnership**
- 4 Was a return of income filed for preceding year? **Yes** If so, to which collector's office was it sent? **Omaha**
- 5 Check whether this return was prepared on the cash ☐ or accrual ☒ basis
- 6 State whether inventories at the beginning and end of the taxable year were valued at (a) cost, or (b) cost or market, whichever is lower
- If any other basis is used, attach statement describing basis fully, state why used and the date inventory was last reconciled with stock
- 7 Is any member of the partnership the spouse, son, or daughter of any other member? (Answer "Yes" or "No") **Yes**
- 8 Did the organization at any time during the taxable year own directly or indirectly any stock of a foreign corporation or of a personal holding company, as defined in section 561 of the Internal Revenue Code? (Answer "Yes" or "No") **No** If answer is "Yes," attach list showing name and address of each such corporation and amount of stockholdings
- 9 Was return of information on Forms 1096 and 1099, or Form W-2a, filed for the calendar year 1950? **Yes** (See Instruction H.)



## Schedule H—BALANCE SHEETS.

ASSETS	Beginning of taxable year		End of taxable year	
	Amount	Total	Amount	Total
1. Cash		\$21,926 96		\$28,106 78
2. Notes and accounts receivable (less reserve)		19,099 17		24,328 99
3. Inventories				
4. Investments				
5. Depreciable assets	\$20,246 59		\$28,814 73	
Less: Reserve for depreciation	10,299 66	9,946 93	15,061 43	13,753 30
6. <del>Land</del> Deferred Expense		337 32		840 51
7. Other assets		32,739 79		35,217 05
8. Total assets		\$84,050 24		\$102,246 63
LIABILITIES				
9. Accounts payable		\$ 575 90		\$ 1,958 46
10. <del>Mortgage</del> Deferred Income		61,711 87		75,628 70
11. Accrued expenses		3,463 03		1,047 02
12. Other liabilities				1,766 20
13. Partners' capital accounts:				
(a)				
(b) Mark E. Schlude	\$ 8,984 55		\$ 10,702 99	
(c)				
(d) Margalie Schlude	9,314 89		11,143 26	
(e)		18,299 44		21,846 25
14. Total liabilities		\$ 84,050 24		\$102,246 63

## Schedule I.—RECONCILIATION OF PARTNERS' CAPITAL ACCOUNTS

	Capital account at beginning of year	Ordinary net income	Capital gains and non-taxable income	Additional capital contributed during year	Unallowable deductions	Withdrawals	Capital account at end of year
(a)	\$ 8,984 55	\$ 12,605 93		\$ 2,221 10	\$ 112 50	\$ 12,286 09	\$ 10,702 99
(b)							
(c)							
(d)	9,314 89	12,605 92		2,221 11	112 50	12,886 16	11,143 26
(e)							

## Schedule J.—PARTNERS' SHARES OF INCOME AND CREDITS. (See Instruction for Schedule J)

	1. Name and address of each partner (Designate nonresident alien, if any) Where return of partner or member is filed in another collection district, specify district	2. Percentage of time devoted to business	3. Ordinary net income (item 26, page 1) less any partially tax-exempt interest included in item 7, page 1	4. Partially tax-exempt interest included in item 7, page 1
(a)				
(b)	Mark E. Schlude	Full	12,605 93	
(c)				
(d)	Margalie Schlude	Full	12,605 92	
(e)				
Total				

## CONTINUATION OF SCHEDULE J

	5. Net short-term gain (or loss) from sale or exchange of capital assets (from item 27, page 1)	6. Net long-term gain (or loss) from sale or exchange of capital assets (from item 28, page 1)	7. Charitable contributions (from Schedule F)	8. Federal income tax paid at source (2 percent of item 6, page 1)	9. Income and profits taxes paid to a foreign country or United States possession
(a)					
(b)			112 50		
(c)					
(d)			112 50		
(e)					
Total			225 00		

## DECLARATION (See Instruction D)

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me, and to the best of my knowledge and belief is a true, correct, and complete return.

*G. Schlude, Jr.*  
(Signature of person (other than partner or member) preparing return)

(Date)

7-23-51

(Signature of partner or member)

(Date)

(Name of firm, if employer, if any)

(Address of partner or member)

## Arthur Murray Dance Studio

For the Year Ended March 31, 1951.

Description	Amount
Royalties to Arthur Murray, Inc.	\$15,885.12
Advertising	15,075.66
Records	517.04
Instructors supplies	298.98
Office stationery & supplies	1,640.21
Insurance	457.64
Janitor Service	1,200.00
Heat, light, and power	1,200.94
Telephone & Telegraph	3,099.57
Professional Services	3,491.45
Automobile expenses	728.91
Travel & Convention expenses	4,057.41
Club dues & entertainment	1,959.46
Contests and Party Entertainments	1,029.50
Dues & Subscriptions	56.37
Miscellaneous expenses	2,633.71
Tuition paid other Arthur Murray Dance Studios	751.10
Cost of training instructors (including rent of training quarters)	1,000.00
	<u>\$55,082.17</u>

# U. S. PARTNERSHIP RETURN OF INCOME

1951

(To Be Filed Also by Syndicates, Pools, Joint Ventures, Etc.)  
For Calendar Year 1951

or taxable year beginning April 1, 1951, and ending March 31, 1952

(PRINT PLAINLY NAME AND BUSINESS ADDRESS OF THE ORGANIZATION)

ARTHUR MURRAY DANCE STUDIO

(Name)

309 South 19th Street

(Street and number)

Omaha

(City, town, or post office)

Nebraska

(Postal zone number)

(State)

Principal business activity (see Instruction J) Instruction of Ballroom

Dancing

Do Not Write in These Spaces

PN

25417

(Date Received)

RECEIVED

FEB 5 1952

DIR. INT. REV.  
OMAHA

47

Item and  
Instruction No.

## GROSS INCOME

1. Gross receipts from business or profession \$ 170,811.03
2. Less cost of goods sold:
  - (a) Inventory at beginning of year \$
  - (b) Merchandise bought for sale
  - (c) Cost of labor, supplies, etc
  - (d) Total of lines (a), (b), and (c) \$
  - (e) Less inventory at end of year
3. Gross profit (or loss) from business or profession (item 1 less item 2) \$ 170,811.03
4. Income (or loss) from other partnerships, syndicates, pools, etc. (State separately name, address, and amount)

## Dividends

6. Interest on bank deposits, notes, corporation bonds, etc. (except interest to be reported in item 7) 4,041.21
7. Interest on tax-free covenant bonds upon which a Federal tax was paid at source
8. Interest on Government obligations, etc., unless wholly exempt from tax
9. Rents
10. Royalties
11. Net gain (or loss) from sale or exchange of property other than capital assets (from line 2, Schedule A (2))
12. Other income. (State nature of income)
13. Total income in items 3 to 12 \$ 174,852.24

## DEDUCTIONS

14. Salaries and wages. (Do not include compensation for partners) \$ 57,539.09
15. Rent 10,155.89
16. Interest on indebtedness. (Explain in Schedule B. Do not include interest on capital invested in the business by any partner)
17. Taxes. (Explain in Schedule C) 1,983.29
18. Losses by fire, storm, shipwreck, or other casualty, or theft. (Submit schedule)
19. Bad debts. (Explain in Schedule D)
20. Depreciation. (Explain in Schedule E) 7,134.38
21. Repairs 1,321.80
22. Amortization of emergency facilities. (Attach statement)
23. Depletion of mines, oil and gas wells, timber, etc. (Submit schedule)
24. Other deductions authorized by law. (Explain in Schedule F) 59,133.46
25. Total deductions in items 14 to 24 137,267.91
26. Ordinary net income (item 13 less item 25) \$ 37,584.33
27. Net short-term capital gain (or loss) (from line 3, Schedule A (1)) \$ (4.06)
28. Net long-term capital gain (or loss) (from line 6, Schedule A (1)) \$ 343.79

[Col. 49] EXHIBIT 4 D TO STATEMENT OF FACTS

EXHIBIT 4-D

7-1





151.50 Other Deductions—Schedule F, Page 3

Arthur Murray Dance Studio

For the Year Ended March 31, 1952

Description	Amount
Royalties to Arthur Murray, Inc.	\$19,006.83
Advertising	15,030.39
Records	910.92
Instructor's Supplies	125.00
Office Stationery and Supplies	1,027.18
Insurance	635.52
Janitor Service	1,200.00
Heat, Light and Power	1,246.00
Telephone and Telegraph	3,455.32
Professional Services	2,370.00
Automobile Expense	138.47
Travel and Convention	2,823.86
Club Dues and Entertainment	3,086.49
Contests and Party Entertainment	1,855.35
Dues and Subscriptions	212.85
Miscellaneous Expenses	2,157.78
Tuition Paid Other Arthur Murray Dance Studios	825.00
Cost of Training Instructors (Including rent of Training Quarters)	525.00
Cash over short	48.57
Total	\$59,133.46

fol 58

(2) Contributions or Gifts Paid, Schedule G, Part

Arthur Murray Dance Studio

For the Year Ended March 31, 1966

Name	Amount
American Cancer Society	15.00
St. Catherine's Hospital	50.00
Veterans of Foreign War	20.00
Disabled American Vet	10.00
American War Dads	5.00
Sister Elizabeth Kenny Foundation	10.00
Omaha Community Chest	50.00
Nebraska T. B. Association	10.00
Father Flanigan's Boys Home	15.00
The Nebraska Society for Crippled Children	5.00
American Red Cross	50.00
Knights of Columbus	10.00
National War Casualties	5.00
Total	\$175.00

## Schedule E.—DEPRECIATION. (See instruction 20)

Page 3

Kind of property (if buildings, state material of which constructed) (Include land and other nondepreciable property)	2 Date acquired	3 Cost or other basis	4 Depreciation allowed (or allowable) to prior years	5 Remaining cost or other basis to be depreciated	6 (a) Use used in computing depreciation	7 (b) Estimated life (in years)	8 Depreciation allowed this year
Music Machines	Various	\$ 2,344.45	\$ 1,853.57		2 yrs.		\$ 278.94
Automobiles	Various	10,700.00	-0-		3 yrs.		3,480.41
Furniture & Fixtures	Various	13,708.76	7,394.99		5 yrs.		2,524.56
Leasehold Improvements	Various	8,396.56	4,061.74		Various		850.47

Total (enter as item 20, page 1)

\$ 7,134.38

## Schedule F.—OTHER DEDUCTIONS. (See instruction 24)

SEE SCHEDULE ATTACHED

Total (enter as item 24, page 1)

\$

## Schedule G.—CONTRIBUTIONS OR GIFTS PAID. (See instruction for Schedule K)

SEE ATTACHED SCHEDULE

Total (enter in column 7, Schedule K)

\$

## Schedule H.—COMPUTATION OF NET EARNINGS FROM SELF-EMPLOYMENT. (See instructions for Schedule H)

1 Ordinary net income increased by casualty losses (item 26 plus item 18, page 1, but do not include any income from excluded services)		\$ 37,584.33
2 Less Portion of item 4, page 1, which does not constitute net earnings from self-employment	\$	
3 Dividends from item 5, page 1		
4 Interest on corporation bonds and Government obligations, etc., included in items 6, 7, and 8, page 1	4,041.21	
5 Net rentals from real estate (item 9, page 1, less allowable deductions)		4,041.21
6 Net gain (or loss) from item 11, page 1		
7 Net earnings from self-employment (Enter in column 10, Schedule R)		\$ 33,543.12

## QUESTIONS

Date of organization June 18, 1946

- 2 If this is the organization's first return, indicate whether (a) completely new business ☐ or (b) successor to previously existing business, which was organized as (1) corporation ☐, (2) partnership ☐, or (3) sole proprietorship ☐, or (4) other indicate

If successor to previously existing business, give name and address of the previous business organization

- 3 Nature of organization (partnership, syndicate, pool, joint venture, etc.) **Partnership**

- 4 Was a return of income filed for preceding year? **Yes** If so, to which collector's office was it sent?

**Omaha**

- 5 Check whether this return was prepared on the cash ☐ or accrual ☒ basis

- 6 State whether inventories at the beginning and end of the taxable year were valued at (a) cost, or (b) cost or market whichever is lower **Not Applicable**

If any other basis is used, attach statement describing basis fully, state why used and the date inventory was last reconciled with stock

Is any member of the partnership the spouse, son, or daughter of any other member? (Answer "Yes" or "No") **Yes**

- 8 Did the organization at any time during the taxable year own directly or indirectly any stock of a foreign corporation or of a personal holding company, as defined in section 501 of the Internal Revenue Code? (Answer "Yes" or "No") **No** If answer is "Yes," attach list showing name and address of each such corporation and amount of stockholdings

- 9 Was return of information on Forms 1096 and 1099, or Form W-2a, filed for the calendar year 1951? (See instruction H) **Yes**

[101.52]

13

8 5

ASSETS	Beginning of taxable year		End of taxable year	
	Amount	Total	Amount	Total
1. Cash		\$ 28,106.78		\$ 38,292.42
2. Notes and accounts receivable (less reserve)		24,328.99		37,927.23
3. Inventories				
4. Investments				
5. Depreciable assets	\$ 28,814.73		\$ 35,149.77	
Less: Reserve for depreciation	13,061.43	13,753.30	20,074.83	15,074.94
6. <del>XXXXX</del> DEFERRED EXPENSE		840.51		983.09
7. Other assets		35,217.05		38,308.97
8. Total assets		\$ 102,246.63		\$ 130,586.65
LIABILITIES				
9. Accounts payable		\$ 1,958.46		\$ 2,698.82
10. <del>XXXXX</del> DEFERRED INCOME		75,628.70		105,443.92
11. Accrued expenses		1,047.02		2,092.36
12. Other liabilities		1,766.20		2,540.40
13. Partners' capital accounts:				
(a)				
(b) Mark E. Schlude	\$ 10,702.99		\$ 8,804.79	
(c)				
(d) Marzalie Schlude	11,143.26		9,006.36	
(e)		21,846.25		17,811.15
14. Total liabilities		\$ 102,246.63		\$ 130,586.65

## Schedule J.—RECONCILIATION OF PARTNERS' CAPITAL ACCOUNTS

	1. Capital amount at beginning of year	2. Ordinary net income	3. Capital gains and losses and other income	4. Additional capital contributed during year	5. Capital losses and other deductions	6. Withdrawals	7. Capital amount at end of year
(a)	\$	\$	\$	\$	\$	\$	\$
(b)	10,702.99	18,792.16	171.90		91.03	20,771.23	8,804.79
(c)							
(d)	11,143.26	18,792.17	171.89		91.03	21,009.93	9,006.36

## Schedule K.—PARTNERS' SHARES OF INCOME AND CREDITS. (See instruction for Schedule K.)

1. Name and address of each partner (Designate nonresident alien, if any) Where return of partner or member is filed in another collection district, specify district		2. Percentage of loss derived from business	3. Ordinary net income (from line 2, page 1) less any partially tax exempt interest included in line 3, page 1	4. Partially tax exempt interest included in line 3, page 1
(a)			\$	\$
(b) Mark E. Schlude		Full	18,792.16	
(c)				
(d) Marzalie Schlude		Full	18,792.17	
(e)				
Totals			\$ 37,584.33	\$

## Continuation of Schedule K

	5. Net short term gain (or loss) from sale or exchange of capital assets (from line 1, Schedule A)	6. Net long term gain (or loss) from sale or exchange of capital assets (from line 4, Schedule A)	7. Charitable contributions (from Schedule B)	8. Federal income tax paid at source (7 percent of item 3, page 1)	9. Income and profits taxes paid to a foreign country or United States possession	10. Net earnings from self-employment (from line 7, Schedule K, page 2)
(a)	\$	\$	\$	\$	\$	\$
(b)	(2.03)	171.90	89.00			
(c)						
(d)	(2.03)	171.89	89.00			
(e)						
Totals	\$ (4.06)	\$ 343.79	\$ 178.00	\$	\$	\$

## DECLARATION (See instruction D)

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me, and to the best of my knowledge and belief is a true, correct, and complete return.

(Signature of person (other than partner or member) preparing return)

(Date)

(Signature of partner or member)

(Date)

(Name of firm or employer, if any)

U. S. GOVERNMENT PRINTING OFFICE

16-64258-1

(Address of partner or member)



# U. S. PARTNERSHIP RETURN OF INCOME

1952

(To Be Filed Also by Syndicates, Pools, Joint Ventures, Etc.)

For Calendar Year 1952

or taxable year beginning April 1, 1952, and ending Mar. 31, 1953

(PRINT PLAINLY NAME AND BUSINESS ADDRESS OF THE ORGANIZATION)

Arthur Murray Dance Studio

309 So. 19th Street

Omaha

Nebraska

(City, town, or post office)

(Postal zone number)

(State)

Principal business activity (see Instruction J)

Instruction of  
Ballroom Dancing

Do Not Write In These Spaces

Serial

833

(Date Received)

JUL 28 1953

47

DIR. INT. R. & H.  
OMAHA

Item and  
Instruction No.

## GROSS INCOME

1. Gross receipts from business or profession ..... \$ 266,088 55
2. Less cost of goods sold:
  - (a) Inventory at beginning of year ..... \$
  - (b) Merchandise bought for sale .....
  - (c) Cost of labor, supplies, etc. ....
  - (d) Total of lines (a), (b), and (c) ..... \$
  - (e) Less inventory at end of year .....
3. Gross profit (or loss) from business or profession (item 1 less item 2) ..... \$ 266,088 55
4. Income (or loss) from other partnerships, syndicates, pools, etc. (State separately name, address, and amount): .....
5. Dividends .....
6. Interest on bank deposits, notes, corporation bonds, etc. (except interest to be reported in item 7) ..... \$ 8,098 50
7. Interest on tax-free covenant bonds upon which a Federal tax was paid at source .....
8. Interest on Government obligations, etc., unless wholly exempt from tax .....
9. Rents .....
10. Royalties .....
11. Net gain (or loss) from sale or exchange of property other than capital assets (from line 2, Schedule A (2)) .....
12. Other income. (State nature of income): .....
13. Total income in items 3 to 12 ..... \$ 274,187 05

## DEDUCTIONS

14. Salaries and wages. (Do not include compensation for partners) ..... \$ 98,602 14
15. Rent ..... 14,296 96
16. Interest on indebtedness. (Explain in Schedule B. Do not include interest on capital invested in the business by any partner) .....
17. Taxes. (Explain in Schedule C) ..... 2,496 30
18. Losses by fire, storm, shipwreck, or other casualty, or theft. (Submit schedule) .....
19. Bad debts. (Explain in Schedule D) .....
20. Depreciation. (Explain in Schedule E) ..... 8,007 01
21. Repairs .....
22. Amortization of emergency facilities. (Attach statement) .....
23. Depletion of mines, oil and gas wells, timber, etc. (Submit schedule) .....
24. Other deductions authorized by law. (Explain in Schedule F) ..... 99,988 28
25. Total deductions in items 14 to 24 ..... 223,390 69
26. Ordinary net income (item 13 less item 25) ..... \$ 50,796 36
27. Net short-term capital gain (or loss) (from line 3, Schedule A(1)) ..... \$
28. Net long-term capital gain (or loss) (from line 6, Schedule A(1)) ..... \$ 1,991 80

EXHIBIT 5-B

[Vol. 33] EXHIBIT 5-B TO STATEMENT OF FACTS

## (1) CAPITAL ASSETS. (See Instructions 27-28)

1. Kind of property (If necessary, attach statement of descriptive details not shown below)	2. Date acquired Mo. Day Year	3. Date sold Mo. Day Year	4. Gross sales price (see instructions)	5. Depreciation allowed (see instructions) or other basis adjustment (attach schedule)	6. Cost or other basis and cost of subsequent improvements (if not purchased, attach explanation)	7. Capital gain or loss	8. Gain or loss (column 7 plus the sum of columns 5 and 6)
SHORT TERM CAPITAL GAINS AND LOSSES—ASSETS HELD NOT MORE THAN 12 MONTHS							
1.			\$	\$	\$	\$	\$
2. Enter share of net short-term gain or loss from other partnerships and from common trust funds							
3. Enter here the sum of short-term gains or losses or difference between short-term gains and losses shown above. Also enter as item 27, page 1, and in column 5, Schedule K							\$

## LONG TERM CAPITAL GAINS AND LOSSES—ASSETS HELD MORE THAN 12 MONTHS

4. Cadillac Conv.	5-51	5-52	3775	00 1134	70 4085	00 \$	824	70
Jaguar	5-51	2-53	3000	00 2291	00 4123	90	1167	10
5. Enter the full amount of share of net long-term gain or loss from other partnerships and from common trust funds							1991	80
6. Enter here the sum of long-term gains or losses or the difference between long-term gains and losses shown above. Also enter as item 28, page 1, and in column 6, Schedule K								

## (2) PROPERTY OTHER THAN CAPITAL ASSETS. (See Instruction 11)

1.	\$	\$	\$	\$	\$
2. Enter here the sum of gains or losses or difference between gains and losses shown above. Also enter as item 11, page 1					

## Schedule B.—INTEREST ON INDEBTEDNESS. (See Instruction 18)

Explanation	Amount	Explanation (continued)	Amount (continued)
	\$		\$
Total (enter as item 16, page 1)			\$

## Schedule C.—TAXES. (See Instruction 17)

Explain	Amount	Explain (continued)	Amount (continued)
Payroll Taxes	\$ 2037 16		\$
General Taxes	459 14		
Total (enter as item 17, page 1)			\$ 2496 30

## Schedule D.—BAD DEBTS. (See Instruction 19)

1. Taxable year	2. Net income reported	3. Sales on account	4. Bad debt of organization if no reserve is carried on books	5. Gross amount added to reserve	6. Amount charged against reserve
1949	\$	\$	\$	\$	\$
1950					
1951					
1952					

NOTE.—Check whether deduction claimed represents debts which have become worthless ☐ or is an addition to a reserve ☐

[fol. 54]

Contributions or Gifts Paid—Schedule G, Page 3.

63

Arthur Murray Dance Studio.

For the Year-Ended March 31, 1953.

Name	Amount
American Cancer Society.....	\$ 5.00
Flood Relief—Omaha, Nebraska.....	51.70
Boys Town.....	5.00
Disabled American Vet.....	20.00
Sister Kenny Foundation.....	20.00
Immanuel Deaconess Institute.....	10.00
Community Chest.....	60.00
National War Casualties.....	11.00
Father Flannigan.....	5.00
Nebraska T. B. Association.....	5.00
Salvation Army.....	5.00
March of Dimes.....	10.00
Red Cross.....	35.00
National Society for Crippled Children.....	20.00
Veterans of Foreign Wars.....	10.00
	<hr/>
	\$272.70

[fol. 55]

Other Deductions—Schedule F, Page 3.

Arthur Murray Dance Studio.

For the Year Ended March 31, 1953.

Description	Amount
Royalties to Arthur Murray, Inc.....	\$30,657.21
Advertising .....	30,998.13
Autonobile Expense.....	934.64
Instructors' Supplies.....	617.72
Office Stationery & Supplies.....	1,726.15
Records .....	1,050.83
Travel and Convention.....	3,340.15
Insurance .....	917.21
Club Dues and Entertainment.....	1,697.64
Repairs & Maintenance and Janitor Service.....	3,514.38
Heat, Light & Power.....	2,001.16
Telephone and Telegraph.....	5,322.40
Professional Services.....	3,431.50
Contests, Party and General Promotional.....	8,375.23
Miscellaneous Expenses.....	2,599.45
Tuition paid other Arthur Murray Dance Studios.....	1,328.13
Cost of training instructors (including rent of training quarters).....	421.14
Collection Expense.....	200.00
Bad Debts—Employees.....	290.00
Cash Over/Short.....	248.10
Dues and Subscriptions.....	317.11

\$99,988.28



1. Kind of property or interest in real or personal property	2. Date acquired	3. Cost or other basis	4. Depreciation allowed (or allowable) to prior years	5. Remaining cost or other basis to be recovered	6. Life used in accumulating depreciation	7. Estimated life from the beginning of year	8. Depreciation allowed for the year
Music Machines	Var.	\$ 2568 00	2132 51		2		\$ 180 88
Automobiles		11,990 17	830 36		3		3100 62
Furniture & Fixtures		17,836 64	9919 55		5		2169 15
Leasehold Improvements		19,501 66	4212 22		Var.		2556 36
Total (enter as item 20, page 1)							\$8007 01

See Attached Schedule

Total (enter as item 24, page 1) \$99,988 28

Schedule G.—CONTRIBUTIONS OR GIFTS PAID. (See instruction for Schedule K)	Amount	Name and address of organization (method)	Amount (method)
	\$		\$

See Attached Schedule

Total (enter in column 7, Schedule K) \$ 272 70

Schedule N.—COMPUTATION OF NET EARNINGS FROM SELF-EMPLOYMENT. (See instructions for Schedule N)	
1. Ordinary net income increased by casualty losses (item 26, plus item 16, page 1, but do not include any income from excluded services or sources)	\$0,796 36
2. Less: Portion of item 4, page 1, which does not constitute net earnings from self-employment	
3. Dividends from item 5, page 1	
4. Interest on corporation bonds and Government obligations, etc., included in items 6, 7, and 8, page 1	
5. Net rentals from real estate (item 9, page 1, less allowable deductions)	
6. Net gain (or loss) from item 11, page 1	
7. Net earnings from self-employment. (Enter in column 10, Schedule K)	\$0,796 36

#### QUESTIONS

1. Date of organization June 18, 1946
2. If this is the organization's first return, indicate whether (a) completely new business ☐ or (b) successor to previously existing business, which was organized as (1) corporation ☐, (2) partnership ☐, or (3) sole proprietorship ☐, or (4) other (indicate) Partnership  
If successor to previously existing business, give name and address of the previous business organization
3. Nature of organization (partnership, syndicate, pool, joint venture, etc.) Partnership
4. Was a return of income filed for preceding year? Yes ☒ If so, to which director's (formerly collector's) office was it sent? Omaha
5. Check whether this return was prepared on the cash ☐ or accrual ☒ basis.
6. State whether inventories at the beginning and end of the taxable year were valued at (a) cost, or (b) cost or market whichever is lower it applicable  
If any other basis is used, attach statement describing

7. Is any member of the partnership the wife, son, or daughter of any other member (Answer "Yes" or "No.") Yes
8. Did the organization at any time during the taxable year own directly or indirectly any stock of a foreign corporation or of a personal holding company, as defined in section 501 of the Internal Revenue Code? (Answer "Yes" or "No.") No If answer is "Yes," attach list showing name and address of each such corporation and amount of stockholdings
9. Was return of information on Forms 1096 and 1099, or Form W-2a, filed for the calendar year 1952? (See Instruction H) Yes
10. Did the partnership, during the taxable year, have any contracts or subcontracts subject to the Renegotiation Act of 1951? (Answer "yes" or "no") No If answer is "Yes," state the approximate aggregate gross dollar amount bill 1 during the taxable year under all such contracts and/or subcontracts \$ (See General Instruction K)

ASSETS		Beginning of taxable year		End of taxable year	
		Amount	Total	Amount	Total
1. Cash			\$ 38,292 42		\$ 51,827 72
2. Notes and accounts receivable		\$ 37,924 23		\$ 86,698 33	
Less: Reserve for bad debts			37,927 23		86,698 33
3. Inventories					
4. Investments					
5. Depreciable assets		\$ 35,149 77		\$ 51,991 47	
Less: Reserve for depreciation		20,074 83	15,074 94	23,956 15	28,035 32
6. Land	Deferred Expense		983 09		874 78
7. Other assets			38,308 97		83,822 20
8. Total assets			\$ 130,586 65		\$ 251,258 35
LIABILITIES					
9. Accounts payable			\$ 2,698 82		\$ 4,754 10
10. Notes and mortgages payable	Deferred Income		105,443 92		235,942 33
11. Accrued expenses			2,092 36		2,834 40
12. Other liabilities			2,540 40		289 80
13. Partners' capital accounts:					
(a)		\$		\$	
(b) Mark E. Schlude		8,804 79		2,919 67	
(c)					
(d) Maryalie Schlude		9,006 36		4,518 05	
(e)			17,811 15		7,437 72
14. Total liabilities			\$ 130,586 65		\$ 251,258 35

**Schedule J.—RECONCILIATION OF PARTNERS' CAPITAL ACCOUNTS**

	1. Capital amount at beginning of year	2. Ordinary net income	3. Capital gains and losses and other income	4. All other capital gains and losses during year	5. Capital losses and other deductions	6. Withdrawals	7. Capital amount at end of year
(a)	\$	\$	\$	\$	\$	\$	\$
(b)	8,804 79	25,398 18	995 90		136 35	32,242 85	2,919 67
(c)							
(d)	9,006 36	25,398 18	995 90		136 35	30,746 04	4,518 05
(e)							

**Schedule K.—PARTNERS' SHARES OF INCOME AND CREDITS. (See instruction for Schedule K.)**

1. Name and address of each partner (Designate nonresident, if any) (Where return of partner or member is filed in another collection district, specify district)	2. Percentage of time devoted to business	3. Ordinary net income (from line 2, page 1) less any partner's tax-exempt interest included in line 4, page 1	4. Partially tax-exempt interest included in line 4, page 1
(a) Mark E. Schlude	Full	\$ 25,398 18	\$
(b) Maryalie Schlude	Full	\$ 25,398 18	\$
(c)			
Totals		\$ 50,796 36	\$

**Continuation of Schedule K**

	5. Net short-term gains (or losses) from sale or exchange of capital assets (from line 1, Schedule A)	6. Net long-term gains (or losses) from sale or exchange of capital assets (from line 2, Schedule A)	7. Charitable contributions (from line 1, Schedule C)	8. Federal income tax paid (from line 1, Schedule E)	9. Income and profits taxes paid to a foreign country or United States possession	10. Net earnings from self-employment (from line 1, Schedule M, page 2)
(a)	\$	\$	\$	\$	\$	\$
(b)		995 90	136 35			
(c)						
(d)		995 90	136 35			
(e)						
Totals	\$	\$ 1,991 80	\$ 272 70	\$	\$	\$

**DECLARATION (See instruction D)**

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me, and to the best of my knowledge and belief is a true, correct, and complete return.

(Signature of person filing this return) *Mark E. Schlude* (Date) *7/27/53*  
*Maryalie Schlude* (Signature of partner or member) *7/27/53* (Date)  
*City National Bank Bldg* (Address of partner or member)  
*Amman, Nebraska* (Address of partner or member)

# U. S. PARTNERSHIP RETURN OF INCOME

1953

(To Be Filed Also by Syndicates, Pools, Joint Ventures, Etc.)  
For Calendar Year 1953

or taxable year beginning 4-1, 1953, and ending 3-31, 1954

(PRINT PLAINLY NAME AND BUSINESS ADDRESS OF THE ORGANIZATION)

ARTHUR MURRAY DANCE STUDIO

309 South 19th Street

Omaha

Nebraska

Principal business activity (See Instruction J) Dance Instruction

FICA employee identification number  
if any (See General Instruction K) 47-0354832

Number of places  
of business 6

Do Not Write In These Spaces

RECEIVED

54

REV  
IANA

Item and  
Instruction No.

## GROSS INCOME

1. Gross receipts from business or profession \$ 370,702.89
2. Less cost of goods sold:
  - (a) Inventory at beginning of year \$
  - (b) Merchandise bought for sale
  - (c) Cost of labor, supplies, etc
  - (d) Total of lines (a), (b), and (c) \$
  - (e) Less inventory at end of year
3. Gross profit (or loss) from business or profession (item 1 less item 2) \$
4. Income (or loss) from other partnerships, syndicates, pools, etc. (State separately name, address, and amount)
5. Dividends
6. Interest on bank deposits, notes, corporation bonds, etc. (except interest to be reported in item 7)
7. Interest on tax-free covenant bonds upon which a Federal tax was paid at source
8. Interest on Government obligations, etc., unless wholly exempt from tax
9. Rents
10. Royalties
11. Net gain (or loss) from sale or exchange of property other than capital assets (from line 2, Schedule A (2))
12. Other income. (State nature of income)
13. Total income in items 3 to 12 \$ 370,702.89

## DEDUCTIONS

14. Salaries and wages. (Do not include compensation for partners) \$ 137,245.16
15. Rent 16,687.50
16. Interest on indebtedness. (Explain in Schedule B. Do not include interest on capital invested in the business by any partner)
17. Taxes. (Explain in Schedule C) 4,075.12
18. Losses by fire, storm, shipwreck, or other casualty, or theft. (Submit schedule)
19. Bad debts. (Explain in Schedule D)
20. Depreciation. (Explain in Schedule E) 12,259.10
21. Repairs
22. Amortization of:
  - (a) Emergency facilities. (Attach statement)
  - (b) Grain storage facilities. (Attach statement)
23. Depletion of mines, oil and gas wells, timber, etc. (Submit schedule)
24. Other deductions authorized by law. (Explain in Schedule F) 131,342.88
25. Total deductions in items 14 to 24 301,609.76
26. Ordinary net income (item 13 less item 25) \$ 69,093.13
27. Net short-term capital gain (or loss) (from line 3, Schedule A(1)) \$
28. Net long-term capital gain (or loss) (from line 6, Schedule A(1)) \$

[Col. 57] EXHIBIT 6-F TO STATEMENT OF FACTS

EXHIBIT 6-F







[fol. 58]

## Arthur Murray School of Dancing.

For the Year Ended March 31, 1954.

## Description

Royalties paid to Arthur Murray, Inc., New York, N.Y.	\$ 35,633.95
Advertising	
Radio	\$12,405.82
Newspaper	12,588.99
Television	14,276.01
Other	7,427.72
Music Records	46,698.54
Instructors' Supplies	711.74
Office Stationery, Printing and Supplies	1,876.63
Insurance	5,118.67
Automobile Expenses	928.49
Travel and Convention Expense	1,254.12
Club Dues and Entertainment	4,705.11
Contests, Student Parties and General Promotional	2,038.54
Repairs and Maintenance	5,167.71
Heat, Light & Power	4,701.05
Telephone and Telegraph	3,100.85
Professional Services	6,173.80
Dues and Subscriptions	6,821.73
Miscellaneous	325.45
Transfer Hours Paid Other Arthur Murray Dance Schools	4,163.41
Cost of Training	1,955.32
Cash Short	16.00
	12.61

---

\$151,342.88

1. Kind of property (If buildings, state material of which constructed. Exclude land and other nondepreciable property.)	2. Date acquired	3. Cost or other basis	4. Depreciation allowed (or allowable) in prior years	5. Remaining cost or other basis to be depreciated	6. Life used in depreciating (page 1 of 99)	7. Estimated life from beginning of year	8. Depreciation allowed this year
Music Equipment	Various	4,275.31	2,313.39		Various		487.68
Automobiles	"	15,999.97	3,930.98		"		3,718.87
Furniture & Fixtures	"	20,749.07	12,088.70		"		2,408.84
Leasehold Improvements	"	32,016.49	6,768.38		"		5,643.71
Total (enter as item 20, page 1)							\$ 12,259.10

See Attached Schedule

Total (enter as item 24, page 1)

\$

## Schedule G—CONTRIBUTIONS OR GIFTS PAID. (See Instruction for Schedule K)

Name and address of organization	Amount	Name and address of organization (continued)	Amount (continued)
American Cancer Society	85.00	Christ Child	10.00
D.A.V.	25.00	Boys Town	10.00
Disabled Veterans	10.00	Volunteers of America	5.00
Community Chest	50.00	Miscellaneous	30.00
Mehr. I.B. Assn.	5.00	St. Leger Crawley Chapter	20.00
American Red Cross	50.00	Total (enter in column 7, Schedule K)	\$ 300.00

## Schedule H—COMPUTATION OF NET EARNINGS FROM SELF-EMPLOYMENT. (See Instructions for Schedule H)

- Ordinary net income increased by casualty losses (item 26 plus item 18, page 1, but do not include any income from excluded services or sources) \$ 69,093.13
- Less: Portion of item 4, page 1, which does not constitute net earnings from self-employment
- Dividends from item 5, page 1
- Interest on corporation bonds and Government obligations, etc., included in items 6, 7, and 8, page 1
- Net rentals from real estate (item 9, page 1, less allowable deductions)
- Net gain (or loss) from item 11, page 1
- Net earnings from self-employment. (Enter in column 10, Schedule K) \$ 69,093.13

## QUESTIONS

- Date of organization **June 18, 1946**
- If this is the organization's first return, indicate whether (a) completely new business ☐, or (b) successor to previously existing business, which was organized as (1) corporation ☐, (2) partnership ☐, or (3) sole proprietorship ☐, or (4) other (indicate)

If successor to previously existing business, give name and address of the previous business organization

basis fully, state why used, and the date inventory was last reconciled with stock

- Nature of organization (partnership, syndicate, pool, joint venture, etc.) **Partnership**
- Was a return of income filed for preceding year? **Yes**. If so, to which District Director's office was it sent? **Omaha**
- Check whether this return was prepared on the cash ☐ or accrual ☒ basis.
- State whether inventories at the beginning and end of the taxable year were valued at (a) cost, or (b) cost or market whichever is lower
- If any other basis is used, attach statement describing

- Is any member of the partnership the wife, son, or daughter of any other member? (Answer "Yes" or "No.") **Yes**
- Did the organization at any time during the taxable year own directly or indirectly any stock of a foreign corporation or of a personal holding company, as defined in section 501 of the Internal Revenue Code? (Answer "Yes" or "No.") **No**. If answer is "Yes," attach list showing name and address of each such corporation and amount of stockholdings
- Was return of information on Forms 1096 and 1099, or Form W-2a, filed for the calendar year 1953? (See Instruction H) **Yes**
- Did the partnership, during the taxable year, have any contracts or subcontracts subject to the Renegotiation Act of 1951? (Answer "Yes" or "No.") **No**. If answer is "Yes," state the approximate aggregate gross dollar amount billed during the taxable year under all such contracts and/or subcontracts (See General Instruction L.)

**BALANCE SHEETS**

Beginning of taxable year

End of taxable year

**ASSETS**

Amount

Total

Amount

Total

1 Cash		\$ 51,827.72		\$ 109,740.92
2 Notes and accounts receivable	\$ 86,698.33		\$ 86,177.19	
Less: Reserve for bad debts		86,698.33		86,177.19
3 Inventories				26,990.00
4 Investments				
5 Depreciable assets	\$ 51,991.47		\$ 73,040.84	
Less: Reserve for depreciation	\$ 23,956.15	\$ 28,035.32	\$ 36,215.25	\$ 36,825.59
6 Land		874.78		699.04
Deferred Expense		83,822.20		78,880.34
7 Other assets				
8 Total assets		\$ 251,258.35		\$ 338,312.99
<b>LIABILITIES</b>				
9 Accounts payable		\$ 4,754.10		\$ 11,167.53
10 <del>Income tax payable</del> <b>Deferred Income</b>		235,942.33		248,740.30
11 Accrued expenses		2,834.40		4,716.30
12 Other liabilities		289.80		
13 Partners' capital accounts:				
(a) Mark E. Schlude	2,919.67		35,960.26	
(b) Marzalie Schlude	4,518.05		37,678.60	
		7,437.72		73,638.86
14 Total liabilities		\$ 251,258.35		\$ 338,312.99

**Schedule J. - RECONCILIATION OF PARTNERS' CAPITAL ACCOUNTS**

	1. Capital account at beginning of year	2. Ordinary net income	3. Capital gains and losses (this income)	4. Additional capital contributed during year	5. Capital losses and other deductions	6. Withdrawals	7. Capital account at end of year
(a)	\$ 2,919.67	\$ 34,546.57		\$ 21,645.79		\$ 23,151.77	\$ 35,960.26
(b)	4,518.05	34,546.56		21,645.77		23,031.78	37,678.60

**Schedule K. - PARTNERS' SHARES OF INCOME AND CREDITS. (See instruction for Schedule K.)**

	1. Name and address of each partner (Do not list nonresident alien if any. Where place of partner or member is filed in another internal revenue district, specify district.)	2. Percentage of time devoted to business	3. Ordinary net income (from page 11) less any partially tax exempt interest included on page 8, page 1	4. Partially tax exempt interest included on page 8, page 1
(a)	Mark E. Schlude - Omaha, Nebraska	100%	\$ 34,546.57	
(b)	Marzalie Schlude - Omaha, Nebraska	100%	34,546.56	
Totals			\$ 69,093.13	

**Continuation of Schedule K**

	5. Net short-term gain or loss from sale or exchange of capital assets (from line 7, Schedule A)	6. Net long-term gain or loss from sale or exchange of capital assets (from line 8, Schedule A)	7. Charitable contributions (from Schedule G)	8. Federal income tax paid at source (2 percent of line 3, page 1)	9. Income and profits, losses paid to a foreign country or United States possession	10. Net earnings from self-employment (from line 1, Schedule K, page 1)
(a)						
(b)			150.00			34,546.57
(c)			150.00			34,546.56
Totals			300.00			\$ 69,093.13

**DECLARATION (See instruction D)**

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me, and to the best of my knowledge and belief is a true, correct, and complete return.

(Signature of person (other than partner or member) preparing return)

(Date)

(Signature of partner or member)

(Date)

(Name of firm or employer, if any)

U. S. GOVERNMENT PRINTING OFFICE 16-58332-1

(Address of partner or member)

# U. S. INDIVIDUAL INCOME TAX RETURN

1950  
CALENDAR YEAR

For other taxable year ending after Sept. 30, 1950, but before Dec. 31, 1951, attach Form 1040-Y

**EMPLOYEES.** Instead of this form, you may use Form 1040A if your total income was less than \$5,000, consisting wholly of wages shown on Forms W-2, or of such wages and not more than \$100 of other wages, dividends, and interest.

Name **Mark E. Schlude and Marzelle Schlude**  
(PLEASE PRINT. If this is a joint return of husband and wife, use first names of both.)

HOME ADDRESS **309 So. 19th Street**  
(PLEASE PRINT. Street and number or rural route.)

**Omaha**

(City, town, or post office.)

**Nebraska**

(Postal zone number.)

(State.)

Social Security No.

Occupation **Own Dance Studio**

Do not write in these spaces

(Cashier's Stamp)

Your  
exemptions

1. List your own name.  
If married and your wife (or husband) had no husband, or if this is a joint return of husband and wife, list name of your wife (or husband).

List names of other close relatives (as defined in instructions) with 1950 gross incomes of less than \$500 who received more than one-half of their support from you in 1950. If this is a joint return of husband and wife, list dependent relatives of both.

Name (please print)

Check below whether you (or your wife) were at the end of your taxable year—

OR OVER

BLIND

On lines a and b below—  
Write 1 if neither 65 nor blind,  
Write 2 if either 65 or blind,  
Write 3 if both 65 and blind

Your name **Mark**  
Wife's (or husband's) name **Marzelle**

Yes ☐ No ☒ Yes ☐ No ☒  
Yes ☐ No ☒ Yes ☐ No ☒

a. Number of exemptions for you **1**  
b. Number of her (his) exemptions **1**

Name of Other Dependent Relative

Relationship

Address if different from yours

Enter here total number of exemptions claimed (yours and your wife's plus one for each dependent listed above) **2**

Your  
income

2. Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1950, BEFORE PAY-ROLL DEDUCTIONS for taxes, dues, insurance, bonds, etc. Also enter amount of income tax withheld. Members of Armed Forces and persons claiming traveling or reimbursed expenses, see instructions.

Print Employer's Name

Where Employed—City and State

Amount of Income Tax Withheld

Total Wages

\$

\$

Enter totals

\$

\$

3. If you received dividends, interest, or any other income, give details on page 2 and enter the total here

19,948

95

4. Add income shown in items 2 and 3, and enter the total here

19,948

95

How to  
figure  
the tax

IF YOUR INCOME WAS LESS THAN \$5,000. Use the table on page 4 to find your tax unless you itemize your deductions. This table allows about 10 percent of your total income for charitable contributions, interest, taxes, medical expenses, etc. If your deductions exceed 10 percent, it will usually be to your advantage to itemize them and compute your tax on page 3.

IF INCOME WAS \$5,000 OR MORE. Do not use tax table. Compute tax on page 3. Use standard deduction or itemize deductions, whichever is to your advantage.

HUSBAND AND WIFE. For split income benefits, file a joint return. If filing separate returns, and one itemizes deductions, both must itemize.

5. Enter your tax from table on page 4, or from line 18, page 3

\$ 4,076

32

6. How much have you paid on your 1950 income tax?

(A) By tax withheld (in item 2, above). Attach Original Forms W-2

(B) By payments on 1950 Declaration of Estimated Tax

\$ 5,000 00

5,000 00

00

Tax  
due or  
refund

7. If your tax (item 5) is larger than payment (item 6), enter BALANCE OF TAX DUE here

\$

This balance of tax due must be paid in full with return.

8. If your payments (item 6) are larger than your tax (item 5), enter the OVERPAYMENT here

\$ 923

68

Enter amount of item 8 you want Refunded to you \$

Credited on your 1951 estimated tax \$

Do you owe any prior year Federal tax for which you have been billed?

No

(Tax or No Tax)

If you filed a return for a prior year, state latest year

1949

Where filed

Omaha, Nebraska

County in which you reside

Douglas

To which Collector's office did you pay

amount claimed in item 6 (P. above)? Omaha, Nebraska

Is your wife (or husband) making a separate return for 1950?

No

If Yes, attach with return

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

Signature of person other than taxpayer

EXHIBIT 7-0

Marzelle Schlude

3/1/51

Mark E. Schlude

3/1/51

To assure any benefits of sp

Include in this return and BOTH MUST SIGN even though only one has income



Automatic Canteen  
Merchandise Mart  
Chicago, Ill.

62 50

Enter total here →

62 50

**Schedule B.—INCOME FROM INTEREST**

Name and address of payor

Amount

Name and address of payee

Amount

Enter total here →

**Schedule C.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION.** (Farmers should obtain Form 1040F)

Net profit (or loss) from business or profession (from separate Schedule C)

**Schedule D.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS, ETC.**

1. Net gain (or loss) from sale or exchange of capital assets (from separate Schedule D)

2. Net gain (or loss) from sale or exchange of property other than capital assets (from separate Schedule D)

**Schedule E.—INCOME FROM ANNUITIES OR PENSIONS**

1. Cost of annuity (total amount you paid in)

\$

4. Total amount received this year

\$

2. Amount received tax-free in prior years

5. Excess, if any, of line 4 over line 3

3. Remainder of cost (line 1 less line 2)

\$

6. Enter line 5, or 3 percent of line 1, whichever is greater (but do not enter more than line 4)

**Schedule F.—INCOME FROM RENTS AND ROYALTIES**

1. Kind and location of property

2. Amount of rent or royalty

3. Depreciation or depletion (Carry to Schedule M)

4. Royalties (Carry to Schedule M)

5. Other expenses (Carry to Schedule M)

(See schedule attached)

1. Totals

\$

\$

\$

\$

2. Net profit (or loss) (column 2 less sum of columns 3, 4, and 5)

**Schedule G.—INCOME FROM PARTNERSHIPS, ESTATES AND TRUSTS, AND OTHER SOURCES**

NAME

ADDRESS

AMOUNT

1. Partnerships; joint venture, etc.

(See schedule attached)

\$

2. Estate or trust

\$

3. Other sources (state nature)

\$

Enter total here →

18,690 50

Total income (or loss) from above sources (Enter as item 3, page 1)

19,948 95

**Schedule H.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULE F**

1. Kind of property (If buildings, state material of which constructed)

2. Date acquired

3. Cost or other basis (do not include land or other nondepreciable property)

4. Amount fully depreciated in use at end of year

5. Depreciation allowed or allowable in prior years

6. Remaining cost or other basis to be recovered

7. Estimated life used in computing depreciation

8. Estimated remaining life from beginning of year

9. Depreciation allowable this year

**Schedule I.—EXPLANATION OF COLUMNS 4 AND 5 OF SCHEDULE F**

1. Column No.

2. Explanation

3. Amount

1. Column No.

2. Explanation

3. Amount

4-2-2

## SCHEDULE OF GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY

For Calendar Year 1950 or other taxable years ending after Sept. 30, 1950, but before Dec. 31, 1951

NAME AND ADDRESS **Mark E. Schlude & Marzalie Schlude**

## (1) CAPITAL ASSETS

1. Kind of property (If necessary, attach statement of descriptive details, not shown below)	2. Date acquired Mo. Day Year	3. Date sold Mo. Day Year	4. Gross sales price (contract price)	5. Depreciation allowed (or allowable loss at purchase or March 1, 1913; attach schedule)	6. Cost or other basis and cost of subsequent im- provements (If not purchased, attach explanation)	7. Expenses of sale
<b>SHORT-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD NOT MORE THAN 6 MONTHS</b>						
1. Totals			\$	\$	\$	\$
2. Net short-term gain or loss other than from partnerships and common trust funds (column 4 plus column 5 minus the sum of columns 6 and 7, of line 1)						\$
3. Enter your share of the net short-term gain or loss from partnerships and common trust funds						\$
4. Enter here the sum of gains or losses, or difference between gain and loss, shown in lines 2 and 3						\$

**LONG-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR MORE THAN 6 MONTHS**

Krenn & Dato Lots	1941	8/29/51	300000	\$	-	\$ 370 51	\$	3	00
Krenn & Dato Lots	1941	12/29/50	150000	\$	-	286 89	\$	2	20

(Taxpayer owned a 1/2 interest in these properties)

1. Totals			\$4500 00	\$	-	\$ 657 40	\$	5	20
6. Net long-term gain or loss other than from partnerships and common trust funds (column 4 plus column 5 minus the sum of columns 6 and 7, of line 5)							\$	1918	70
7. Enter the full amount of your share of the net long-term gain or loss from partnerships and common trust funds							\$	1918	70
8. Enter here the sum of gains or losses, or difference between gain and loss, shown in lines 6 and 7							\$	959	35
9. Enter 50 percent of line 8. This is the amount to be taken into account in summary below							\$	959	35
10. Summary of Capital Gains (use only if gains exceed losses in lines 4 and 9):							\$	959	35

(a) Net gain for 1950 (either the sum of gains or difference between gains and losses in lines 4 and 9)

(b) Capital loss carry-over, 1945-1949 inclusive

(c) If line (a) exceeds line (b), enter this excess here and on line 1, Schedule D, page 2, Form 1040

(d) If line (b) exceeds line (a), enter the excess here and use line (c) to determine allowable loss

(e) Enter here and on line 1, Schedule D, page 2, Form 1040, the smallest of the following: (1) the amount on line (d), (2) net income (adjusted gross income if tax table is used) computed without regard to capital gains or losses, or (3) \$1,000

(f) Enter here the amount on line (c) plus any capital loss carry-over from 1945 which was not used against line (a) or in line (e)

(g) Subtract line (f) from line (d) and enter the remainder here. This is your capital loss carry-over to 1951

11. Summary of Capital Losses (use only if losses exceed gains in lines 4 and 9):

(a) Net loss for 1950 (either the sum of losses or difference between losses and gains in lines 4 and 9)

(b) Capital loss carry-over, 1945-1949 inclusive

(c) Total of lines (a) and (b)

(d) Enter here and on line 1, Schedule D, page 2, Form 1040, the smallest of the following: (1) the amount on line (c), (2) net income (adjusted gross income if tax table is used) computed without regard to capital gains or losses, or (3) \$1,000

(e) Enter here the amount on line (d) plus the amount of any 1945 capital loss carry-over not used in line (d)

(f) Subtract line (e) from line (c) and enter the remainder here. This is your capital loss carry-over to 1951

## (2) PROPERTY OTHER THAN CAPITAL ASSETS

1. Kind of property	2. Date acquired Mo. Day Year	3. Date sold Mo. Day Year	4. Gross sales price (contract price)	5. Depreciation allowed (or allowable loss at purchase or March 1, 1913; attach schedule)	6. Cost or other basis and cost of subsequent im- provements (If not purchased, attach explanation)	7. Expenses of sale
1. Totals			\$	\$	\$	\$
2. Net gain or loss (column 4 plus 5 minus the sum of columns 6 and 7)						\$

[Vol. 61]

Marzalie Schlude—1950

75

Marzalie Schlude

Bayard W. Blossat

6756 Oglesby Ave.

Lendol D. Snow

2542 W. 101st St.

1305 W. Chicago Ave.

Rent Income.....\$420.00

Expenses:

Management .....	21.00	
Repairs .....	74.99	
Insurance .....	160.16	256.15

Net Income Before Depreciation.....163.85

Depreciation .....46.18

Net Income.....117.67

$\frac{1}{2}$  Interest.....58.84

Depreciation Schedule:

1. Store
2. 9/18/47
3. \$923.72
4. ....
5. 27.58
6. 896.14
7. 20 years
8. 17 $\frac{3}{4}$  years
9. \$ 46.18



Marzalie Schlude 1 1/2

Harry A. Boissat 1 1/2

6818 Bennett Ave.

7801 South Shore Drive

Gross Income: ..... \$540.60

## Expenses:

Insurance ..... 5.51

Water ..... 4.26

Plumbing Repairs ..... 29.00 38.77

Net Income (Before Depreciation) ..... 501.23

A 1/2 interest ..... 250.62

Deduct depreciation (Taxpayer's share) 404.69

Net Income ..... 154.97

## Depreciation Schedule:

1. Frame House

2. 12-31-49

3. \$6,067.35

4. ....

5. ....

6. 6,067.35

7. 15 years

8. 15 years

9. \$ 404.69

Income From Partnerships and Other Sources.

Arthur Murray Dance Studio

309 So. 19th St.

Omaha, Nebraska.

Mark E. Schlude . . . . . \$ 9,908.23

Marzalie Schlude . . . . . 9,908.25

54th & Woodlawn—University Building

c/o South Central Realty Co.

216 E. 31st St.,

Chicago, Ill.

Marzalie Schlude . . . . . 280.34

Total Partnership Income . . . . . 20,096.75

Oil Well Development Expense . . . . . 1,406.25

Total . . . . . \$18,690.50

(Vol. 64)

Marzalie Schlade—1950

Rents Received

3332 Giles	\$334.82
1305 W. Chicago Ave.	58.84
7801 South Shore Drive	154.07
Total	\$236.00

Marzalie Schlade—1950

3332 Giles

Rental Income	\$378.00
Expenses:	
Liability Insurance	19.50
Net Income (Before Depreciation)	358.50
Deduct Depreciation	26.67
Net Income	331.83

Depreciation Schedule:

1. Brick House
2. August, 1941
3. \$400.00
4. ....
5. \$263.56
6. 196.44
7. 15 years
8. 7 years
9. \$ 26.67

## Information Re: Oil Income and Expense

Lease	Dea and Dry Hole Cost	Total Deductions	Net Income
Talbot Brown Lease Spencer County, Ind.	\$281.25	\$281.25	\$ 281.25
Judith Gregory Lease Henderson County, Ky.	281.25	281.25	281.25
McKay-Engel Lease Effingham County, Ill.	281.25	281.25	281.25
Rice Gregory Lease Henderson County, Ky.	281.25	281.25	281.25
Mary Marshall Lease Henderson County, Ky.	281.25	281.25	281.25
Net Loss			\$1,406.25

Investments made through—  
 Joe Reznik,  
 Evansville, Indiana.

## Marzalie Schlude--1950

Marzalie Schlude ..... 50%

Joseph Z. Willner ..... 50%

120 S. LaSalle St.,

Chicago, Illinois.

## Profit on Lots Sold in 1950.

Krenn &amp; Dato Lots 57, 58, 59, 60, 61, 62, 176 and 177.

Sale #1--8/29/50--Lots 57, 58, 59, 60, 61 and 62

Sales Price .....	\$3,000.00
Cost .....	\$370.51
Sales Expense .....	3.00
Profit (Long Term) .....	2,626.49
50% Taxable .....	1,313.25
Joseph Z. Willner (50%) .....	656.63
Marzalie Schlude (50%) .....	656.63

Sale #2--12/29/50--Lots 176 and 177

Sales Price .....	\$1,500.00
Cost .....	\$286.89
Sales Expense .....	2.20
Profit (Long Term) .....	1,210.91
50% Taxable .....	605.45
Joseph Z. Willner (50%) .....	302.72
Marzalie Schlude (50%) .....	302.73

These deductions and more to whom paid. If more space is needed, list deductions on separate sheet of paper and attach to this return.

<b>Contributions</b>		\$	
	Allowable Contributions (not in excess of 15 percent of item 4, page 1)	\$	
<b>Interest</b>		\$	
	Total Interest	\$	
<b>Taxes</b>		\$	
	Total Taxes	\$	
<b>Losses from fire, storm, or other casualty, or theft</b>		\$	
	Total Allowable Losses (not compensated by insurance or otherwise)	\$	
<b>Medical and dental expenses</b>	Net Expenses (not compensated by insurance or otherwise)	\$	
	Enter 5 percent of item 4, page 1, and subtract from Net Expenses	\$	
<b>Miscellaneous (See instructions)</b>	Allowable Medical and Dental Expenses. See instructions for limitation.	\$	
	Total Miscellaneous Deductions	\$	
<b>TOTAL DEDUCTIONS</b>		\$	

**TAX COMPUTATION—FOR PERSONS NOT USING TAX TABLE ON PAGE 4**

1. Enter amount shown in item 4, page 1. This is your Adjusted Gross Income.	\$	19,948	95
2. Enter DEDUCTIONS. If deductions are itemized above, enter the total of such deductions. If adjusted gross income (line 1, above) is \$5,000 or more and deductions are not itemized, enter the standard deduction of 10 percent of line 1, above, or \$1,000, whichever is the lesser, or \$500 if this is the separate return of a married person.	\$	1,000	00
3. Subtract line 2 from line 1. Enter the difference here. This is your Net Income.	\$	18,948	95
4. Multiply \$600 by total number of exemptions claimed in item 1, page 1. Enter total here.	\$	1,200	00
5. Subtract line 4 from line 3. Enter difference here.	\$	17,748	95
Lines 6, 7, and 8 should be filed in ONLY by a single person or a married person making a separate return.			
6. Use the tax rates shown on page 16 of Instructions to figure your tentative tax on amount shown in line 5 (if line 5, above, includes partially tax-exempt interest, see Instructions). Enter the tentative tax here.	\$		
7. If line 6 is (a) not over \$400, enter 13% of amount on line 6. (b) over \$400 but not over \$100,000, enter \$52 plus 9% of the excess over \$400. (c) over \$100,000, enter \$9,016 plus 7.3% of the excess over \$100,000.	\$		
8. Subtract line 7 from line 6. Enter the difference here. This is your combined normal tax and surtax.	\$		
Lines 9 to 13 should be filed in ONLY if this is a joint return of husband and wife.			
9. Enter here one-half of amount on line 5, above.	\$	8,874	48
10. Use the tax rates shown on page 16 of Instructions to figure your tentative tax on amount shown in line 9 (if line 9, above, includes partially tax-exempt interest, see Instructions). Enter the tentative tax here.	\$	2,257	32
11. If line 10 is (a) not over \$400, enter 13% of amount on line 10. (b) over \$400 but not over \$100,000, enter \$52 plus 9% of the excess over \$400. (c) over \$100,000, enter \$9,016 plus 7.3% of the excess over \$100,000.	\$	219	16
12. Subtract line 11 from line 10. Enter the difference here.	\$	2,038	16
13. Multiply amount on line 12 by 2. Enter this tax here. This is your combined normal tax and surtax.	\$	4,076	32
14. If alternative tax computation is made on separate Schedule D, enter here tax from line 12 on back of Schedule D.	\$		
If you used the standard deduction in line 2, disregard lines 11, 12, and 17, and copy in line 18 the same figure you entered on line 2, 13, or 14, whichever is applicable.			
15. Enter here any income tax payments to a foreign country or U. S. possession (attach Form 1116).	\$		
16. Enter here any income tax paid at source on tax-free government bond interest.	\$		
17. Add the figures on lines 15 and 16 and enter the total here.	\$		
18. Subtract line 17 from line 8, 13, or 14, whichever is applicable. Enter difference here and in item 5, page 1. This is your tax.	\$		

2-10



U. S. INDIVIDUAL INCOME TAX RETURN  
FOR CALENDAR YEAR 1951

1951

or taxable year beginning 1951 and ending 1951

Do not write in these spaces

14456

(Cashier's Stamp)

Name **Mark E. Schlude**  
(PLEASE PRINT. If this is a joint return of husband and wife, use first names of both)

HOME ADDRESS **457 Beverly Drive**  
(PLEASE PRINT. Street and number or rural route)

**Omaha**

**Nebraska**

(City, town, or post office)

(Postal zone number)

(State)

Social Security No. **489-09-3714**

Occupation

14 1952

1. List your name. If your wife (or husband) had no income, or if this is a joint return, list also her (or his) name.

**A Mark E. Schlude**

(Your name)

B

(Your wife's name. Do not list exemption claimed in another return.)

- C. List names of your children (including stepchildren and legally adopted children) with 1951 gross incomes of less than \$600 who received more than one-half of their support from you in 1951. See Instructions.

Enter number of children listed

- D. Enter number of exemptions claimed for close relatives listed in Schedule J on page 2

- E. Enter total number of exemptions claimed in A to D above

2. Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1951, before pay-roll deductions. Persons claiming traveling or reimbursed expenses, see Instructions.

Print Employer's Name

Where Employed (City and State)

Income Tax Withheld

Total Wages

\$

\$

Enter totals

\$

\$

3. If you received dividends, interest, or any other income, give details on page 2 and enter the total here

13341 97

4. Add income shown in items 2 and 3, and enter the total here

\$ 13341 97

IF YOUR INCOME WAS LESS THAN \$5,000.—Use the tax table on page 4 unless you itemize deductions. The table allows about 10 percent of your income for charitable contributions, interest, taxes, medical expenses, etc. If your deductions exceed 10 percent, it will usually be to your advantage to itemize them and compute your tax on page 3. IF INCOME WAS \$5,000 OR MORE.—Compute tax on page 3. Use standard deduction or itemize deductions, whichever is to your advantage.

5. (A) Enter your tax from table on page 4, or from line 13, page 3  
(B) Enter your self-employment tax from line 31, separate Schedule C

\$ 3580 05

81 00

Enter total here →

\$ 3661 05

6. How much have you paid on your 1951 income tax?

(A) By tax withheld (in item 2, above). Attach Original Forms W-2

(B) By payments on 1951 Declaration of Estimated Tax (include any overpayment on your 1950 tax not claimed as a refund)

\$

3000 00

Enter total here →

3000 00

7. If your tax (item 5) is larger than payments (item 6), enter balance of tax due here. This balance must be paid in full with return

\$ 661 05

8. If your payments (item 6) are larger than your tax (item 5), enter the overpayments here

\$

Enter amount of item 8 you want \$

(Refunded)

(Credited on 1952 estimated tax)

Do you owe any prior year Federal tax for which you have been billed? (Yes or No) **No** Is your wife (or husband) making a separate return for 1951? (Yes or No) **Yes** If "yes," write her (or his) name **Marzalie Schlude**

If you have filed a return for a prior year, state latest year **1950** Where filed? **Omaha**

To which Collector's office did you pay amount claimed in item 6 (B), above? **Omaha**

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

(Signature of person, other than taxpayer, preparing this return)

(Date)

(Signature of taxpayer)

(Date)

(Name of sign as employer, if any)

(Signature of taxpayer's wife or husband if this is a joint return)

(Date)

To assure split income benefits, husband and wife must include all their income on BOTH MUST SIGN

EXHIBIT 3-11

Name of corporation (including dividend) Amount \$	<b>Automatic Canteen Corporation</b>	Amount 250 00
		Enter total here → \$ 250 00

Schedule B — INCOME FROM INTEREST			
Name of payer	Amount	Name of payee	Interest
	\$		\$
		Enter total here →	

Schedule C Summary — PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION, FARMING, AND PARTNERSHIP	
1 Business profit (or loss) from separate Schedule C, line 24	\$
2 Farm profit (or loss) from separate schedule, Form 1040F	
3 Partnership, etc., profit (or loss) from Form 1065, Schedule J, Column 10	12605 93
4 Total of lines 1, 2, 3	\$ 12605 93
5 Less Net operating loss deduction (attach statement)	
6 Net profit (or loss) (line 4 less line 5)	12605 93

Schedule D — NET GAIN OR LOSS FROM SALES OR EXCHANGES OF CAPITAL ASSETS, ETC.	
1 From sale or exchange of capital assets (from separate Schedule D)	
2 From sale or exchange of property other than capital assets (from separate Schedule D)	

Schedule E — INCOME FROM ANNUITIES OR PENSIONS	
1 Cost of annuity (amount you paid) \$	4 Amount received this year \$
2 Cost received tax free in past years	5 Excess of line 4 over line 3
3 Remainder of cost (line 1 less line 2) \$	6 Enter line 5, or 3 percent of line 1, whichever is greater (but not more than line 4)

Schedule F — INCOME FROM RENTS AND ROYALTIES					
1. Kind and location of property	2. Amount of rent or royalty	3. Depreciation or depletion (explain in Schedule H)	4. Royalty (explain in Schedule H)	5. Other expenses (explain in Schedule H)	
614-616 Woodland Park -- SEE ATTACHED SCHEDULE					41 14
Oil Income -- Override Oil Deal					94 90
1 Totals	\$	\$	\$	\$	
2 Net profit (or loss) (column 2 less sum of columns 3, 4, and 5)					

Schedule G — INCOME FROM ESTATES AND TRUSTS AND OTHER SOURCES	
1 Estate or trust (Name) (Address)	\$
2 Other sources (state nature) Commission	350 00
Enter total here → \$ 350 00	

Total income (or loss) from above sources (Enter here and as item 3, page 1)	\$ 13341 97
--	-------------

Schedule H — EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SEPARATE SCHEDULE C AND SCHEDULE F							
1. Kind of property (if building, state material of which constructed). (Exclude land and other nondepreciable property)	2. Date acquired	3. Cost or other basis	4. Depreciation allowed (or allowable) in prior years	5. Remaining cost or other basis to be recovered	6. Life used in computing depreciation	7. Estimated life from beginning of year	8. Depreciation allowable this year
		\$	\$	\$			\$

Schedule I — EXPLANATION OF LINES 6, 17, AND 20, SEPARATE SCHEDULE C AND COLUMNS 4 AND 5 OF SCHEDULE F					
Line or Column No.	Explanation	Amount	Line or Column No.	Explanation	Amount
		\$			\$

Schedule J — EXEMPTIONS FOR CLOSE RELATIVES — (See instructions)					
1. Name of dependent relative. Also give address if different from yours	2. Relationship	3. Was dependent during 1951	4. If answer to either 3b) or 3c) is "No" enter number spent for dependent's support in 1951 by—	5. You (and your wife if this is a joint return)	Others, and by dependant (if from own funds)
		(a) Less gross income of 1951 or more?	(b) Excludes to your home?	(c) Excludes under support from you?	
		\$	\$	\$	\$

Enter here and as item 1D, page 1, the number of close relatives claimed above

(Feb. 29)

Mark E. Schlude—1951

Mark E. Schlude ..... 14

Bayard W. Blossat ..... 12

6756 Oglesby Ave.,

Chicago, Illinois.

Harold R. Warner ..... 14

5339 Cornell Ave.,

Chicago, Illinois.

614-616 Woodland Park

(Purchased 12/4/51)

Rent Income: ..... \$625.03

## Expenses:

Light .....	(\$191.60)	
Interest .....	21.58	
Insurance .....	76.87	
Management .....	28.88	
Caretaker .....	12.32	
Water .....	18.10	
Gas .....	( 23.76)	
Plumbing .....	7.50	
Carpenter Repairs .....	350.00	350.64

Net Income Before Depreciation ..... 271.39

Depreciation ..... 106.84

Net Income ..... 164.55

1/4 Interest ..... 41.14

## Depreciation Schedule:

1. 6 apts.—brick
2. 12/4/51
3. \$25,642.25
4. ....
5. \$25,642.25
6. 20 years
7. 20 years
8. \$106.84 (1 Month)

**SCHEDULE OF PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION AND  
COMPUTATION OF SELF-EMPLOYMENT TAX (for old-age and survivors insurance)**

For calendar year 1951 or fiscal year beginning

1951, and ending

1951

Name and address under which Form 1040 is filed **Mark E. Schiude -- Omaha, Nebraska**

If a joint return, name of husband or wife having net earnings from self-employment

**PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION**  
(For reporting farm income, see Form 1040 Instructions)

(1) nature of business **Ballroom Dancing Instruction**  
(2) business name **Arthur Murray Dance Studio**  
(3) business address **309 South 19th Street - Omaha, Nebraska**

**(Do NOT include in this schedule cost of goods withdrawn for personal use or deductions not connected with your business or profession)**

1. Total receipts from business or profession

**COST OF GOODS SOLD**

- 2. Inventory at beginning of year
- 3. Merchandise bought for manufacture or sale
- 4. Cost of labor
- 5. Material and supplies
- 6. Other costs (explain in Schedule I, Form 1040)
- 7. Total of lines 2 to 6
- 8. Less inventory at end of year
- 9. Net cost of goods sold (line 7 less line 8)
- 10. Gross profit (line 1 less line 9)

**OTHER BUSINESS DEDUCTIONS**

- 11. Salaries and wages not included in line 4
- 12. Rent on business property
- 13. Interest on business indebtedness
- 14. Taxes on business and business property
- 15. Bad debts arising from sales or services
- 16. Depreciation and obsolescence (explain in Schedule II, Form 1040)
- 17. Repairs (explain in Schedule I, Form 1040)
- 18. Depletion of mines, oil and gas wells, timber, etc. (submit schedule)
- 19. Amortization of expenses (attach statement)
- 20. Other business expenses (explain in Schedule I, Form 1040)
- 21. Total of lines 11 to 20
- 22. Net profit (or loss) before losses of business property (line 10 less line 21)
- 23. Less losses of business property (attach statement)
- 24. Net profit (or loss) (line 22 less line 23) Enter here and on line 4, Schedule C Summary, page 2, Form 1040

**COMPUTATION OF SELF-EMPLOYMENT TAX (See Instructions on other side)**

- 25. Net earnings (or loss) from self-employment included in line 22, above **NONE**
- 26. Net earnings (or loss) from self-employment from partnerships, joint ventures, etc. (from column 10, Schedule K, page 4, Form 1065) **12605 93**
- 27. Total net earnings (or loss) from self-employment (lines 25 and 26) **12605 93**  
(If total of net earnings is under \$400, do not make any entries below.)
- 28. Wages paid to you during the taxable year which were subject to withholding for old-age and survivors insurance **NONE**
- 29. Total of lines 27 and 28 **12605 93**
- 30. Self-employment income subject to tax  
If line 29 is (a) not over \$3,600, enter amount shown on line 27  
(b) over \$3,600—and amount on line 28 is \$3,600 or more, enter "none"  
—and amount on line 28 is under \$3,600 enter difference between \$3,600 and amount on line 28 **3600 00**
- 31. Self-employment tax—2½ percent of amount shown on line 30. Enter tax here and as item 5(B), page 1, Form 1040 **81 00**

**FILL IN ITEMS BELOW BUT DO NOT DETACH**



ITEMIZED DEDUCTIONS—FOR PERSONS NOT USING TAX TABLE ON PAGE 4 OR STANDARD DEDUCTION ON LINE 2 BELOW—  
If Husband and Wife (Not Legally Separated) File Separate Returns and One Itemizes Deductions, the Other Must Also Itemize.

Page 3

<b>Contributions</b>		\$	
Allowable Contributions (not in excess of 15 percent of item 4, page 1)		\$	
<b>Interest</b>		\$	
Total Interest		\$	
<b>Taxes</b>		\$	
Total Taxes		\$	
<b>Losses from fire, storm, or other casualty, or theft</b>		\$	
Total Allowable Losses (not compensated by insurance or otherwise)		\$	
<b>Medical and dental expenses</b> (if over 65 see instructions)		\$	
Net Expenses (not compensated by insurance or otherwise)		\$	
Enter 5 percent of item 4, page 1, and subtract from Net Expenses		\$	
Allowable Medical and Dental Expenses. See Instructions for limitation		\$	
<b>Miscellaneous</b> (See instructions)		\$	
Total Miscellaneous Deductions		\$	
Total Deductions		\$	

**TAX COMPUTATION FOR CALENDAR YEAR 1961** (For Other Taxable Years Attach Form 1040FY)

1. Enter amount shown in item 4, page 1. This is your Adjusted Gross Income	\$	13341	97
2. If deductions are itemized above, enter total of such deductions. If deductions are not itemized and line 1, above, is \$5,000 or more: (a) married persons filing separately enter \$500, (b) all others enter 10 percent of line 1, but not more than \$1,000		500	00
3. Subtract line 2 from line 1. Enter the difference here. This is your Net Income.	\$	12841	97
4. Multiply \$600 by total number of exemptions claimed in item 1E, page 1. Enter total here		600	00
5. Subtract line 4 from line 3. Enter difference here. (If line 1 includes partially tax-exempt interest, see instructions)	\$	12241	97
6. If line 5 is not more than \$2,000—Enter 20.4 percent of amount on line 5 and disregard lines 7, 8, and 9. This is your normal tax and surtax	\$		
7. If line 5 is more than \$2,000 and you are a single person or a married person filing separately—Use tax rates on last page of instructions to figure tax on amount on line 5. This is your normal tax and surtax	\$	3580	05
8. If line 5 is more than \$2,000 and you are filing a joint return— (a) Enter here one-half of the amount of line 5	\$		
(b) Use tax rates on last page of instructions to figure tax on amount on line 8(a)	\$		
(c) Multiply amount on line 8(b) by 2. This is your normal tax and surtax	\$		
9. If alternative tax computation is made, enter here tax on back of separate Schedule D	\$		
Disregard lines 10, 11, and 12, and copy on line 13 the same figure you entered on line 6, 7, 8(c), or 9, unless you used limited deductions			
10. Enter here any income tax payments to a foreign country or U. S. possession (attach Form 1116)	\$		
11. Enter here any income tax paid at source on tax-free covenant bond interest	\$		
12. Add the figures on lines 10 and 11 and enter the total here	\$		
13. Subtract line 12 from line 6, 7, 8(c), or 9. Enter difference here and as item 5 (A), page 1. This is your tax	\$	3580	05

Do not write in these spaces


Serial No. A7-16443  
(Cashier's Stamp)

43

19

\_\_\_\_\_

On lines A and B below—

H neither 65 nor blind	write the figure 1	
H either 65 or blind	write the figure 2	
H both 65 and blind	write the figure 3	

Number of exemptions for you 61

Number of her (or his) exemptions

Estimated time spent

Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1951, before pay-roll deductions. Persons claiming traveling or reimbursed expenses, see Instructions.

[illegible]

4. Add income shown in items 2 and 3, and enter the total here \$ 133.20

IF YOUR INCOME WAS LESS THAN \$5,000.—Use the tax table on page 4 unless you itemize deductions. The table allows

about 10 percent of your income for charitable contributions, interest, taxes, medical expenses, etc. If your deductions exceed 10 percent, it will usually be to your advantage to itemize them and compute your tax on page 3.

**IF INCOME WAS \$5,000 OR MORE.**—Compute tax on page 3. Use standard deduction or itemize deductions, whichever is to your advantage.

6. How much have you paid on your 1951 income tax?  
(A) By tax withheld (item 2 above). Attach Original Forms W-2

(B) By payments on 1951 Declaration of Estimated Tax (include any overpayment on your 1950 tax not claimed as a refund) \$ 3000.00

8. If your payments (item 6) are larger than your tax (item 5), enter the overpayment here.  
Enter amount of item 8 you want \$ \_\_\_\_\_ \$ \_\_\_\_\_  
(Refunded to you) (If credited on 1982 estimated tax)

If you have filed a return for a prior year, state latest year 1954. Where filed? Union

Robert Morris 3/2/52 Mergel Schulte 3/1/3  
(Signature of person other than taxpayer preparing this return) (Date) (Signature of taxpayer) (Date)

(Name of firm or employer, if any) \_\_\_\_\_ (Signature of taxpayer or husband if this is a joint return) \_\_\_\_\_ (Date) \_\_\_\_\_

To assure split-income benefits, husband and wife must include all their income and, even though \_\_\_\_\_ SIGN \_\_\_\_\_



Schedule A.—INCOME FROM DIVIDENDS		Schedule B.—INCOME FROM INTEREST	
Name of corporation paying dividend	Amount	Name of payor	Amount
	\$		\$
Enter total here →		Enter total here →	

Schedule C Summary.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION, FARMING, AND PARTNERSHIP			
1. Business profit (or loss) from separate Schedule C, line 24	\$		
2. Farm profit (or loss) from separate schedule, Form 1040F			
3. Partnership, etc., profit (or loss) from Form 1065, Schedule J, Column 10	10,282	39	
4. Total of lines 1, 2, 3	\$		
5. Less: Net operating loss deduction (attach statement)			
6. Net profit (or loss) (line 4 less line 5)	10,282	39	

Schedule D.—NET GAIN OR LOSS FROM SALES OR EXCHANGES OF CAPITAL ASSETS, ETC.			
1. From sale or exchange of capital assets (from separate Schedule D)			
2. From sale or exchange of property other than capital assets (from separate Schedule D)	3,002	37	

Schedule E.—INCOME FROM ANNUITIES OR PENSIONS			
1. Cost of annuity (amount you paid)	\$		
2. Cost received tax-free in past years			
3. Remainder of cost (line 1 less line 2)	\$		
4. Amount received this year	\$		
5. Excess of line 4 over line 3			
6. Enter line 5, or 3 percent of line 1, whichever is greater (but not more than line 4)			

Schedule F.—INCOME FROM RENTS AND ROYALTIES				
1. Kind and location of property	2. Amount of rent or royalty	3. Depreciation or depletion (compute in Schedule H)	4. Repairs (compute in Schedule I)	5. Other expenses (compute in Schedule I)
	\$	\$	\$	\$
1. Totals	\$	\$	\$	\$
2. Net profit (or loss) (column 2 less sum of columns 3, 4, and 5)				Loss

Schedule G.—INCOME FROM ESTATES AND TRUSTS AND OTHER SOURCES	
1. Estate or trust (Name) (Address)	\$
2. Other sources (state nature)	Audit fee on above
	50 00
Enter total here →	

Total income (or loss) from above sources (Enter here and as item 3, page 1) \$ 13,361 13

Schedule H.—EXPLANATION OF REDUCTION FOR DEPRECIATION CLAIMED IN SEPARATE SCHEDULE C AND SCHEDULE F							
1. Kind of property (if buildings, state whether of public construction. Exclude land and other nondepreciable property)	2. Date acquired	3. Cost or other basis	4. Depreciation allowed (or allowable) in prior years	5. Remaining cost or other basis to be recovered	6. Life used in computing depreciation	7. Estimated life from beginning of year	8. Depreciation allowable this year
		\$	\$	\$			\$

Schedule I.—EXPLANATION OF LINES 6, 17, AND 20, SEPARATE SCHEDULE C AND COLUMNS 4 AND 5 OF SCHEDULE F					
Line or Column No.	Explanation	Amount	Line or Column No.	Explanation	Amount
		\$			\$

Schedule J.—EXEMPTIONS FOR CLOSE RELATIVES—(See instructions)					
1. Name of dependent relative. Also give address if different from yours	2. Relationship	3. Did dependent (during 1961):		4. If answer to either (b) or (c) is "No," enter amount spent for dependent's support in 1961 by—	
		(a) Have gross income of \$400 or more?	(b) Reside in your home?	(c) Receive more support from you?	Yes (and your wife if this is a joint return)      Others, not by dependent nor from any funds
					\$      \$

Enter here and as item 1D, page 1, the number of close relatives claimed above

# SCHEDULE OF PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION AND COMPUTATION OF SELF-EMPLOYMENT TAX (for old-age and survivors insurance)

For calendar year 1951 or fiscal year beginning

1951, and ending

195

Name and address under  
which Form 1040 is filed

Marvella Schilde - Omaha, Neb.

If a joint return, name of husband or  
wife having net earnings from self-employment

## PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION (For reporting farm income, see Form 1040 Instructions)

1. Nature of business: Ballroom Dancing Instruction  
2. Business name: Arthur Murray Dance Studio  
3. Business address: 309 South 19th Street - Omaha, Nebraska

Do NOT include in this schedule cost of goods withdrawn for personal  
use or deductions not connected with your business or profession

1. Total receipts from business or profession

### COST OF GOODS SOLD

2. Inventory at beginning of year  
3. Merchandise bought for manufacture or sale  
4. Cost of labor  
5. Material and supplies  
6. Other costs (explain in Schedule I, Form 1040)  
7. Total of lines 2 to 6  
8. Less inventory at end of year  
9. Net cost of goods sold (line 7 less line 8)  
10. Gross profit (line 1 less line 9)

### OTHER BUSINESS DEDUCTIONS

11. Salaries and wages not included in line 4  
12. Rent on business property  
13. Interest on business indebtedness  
14. Taxes on business and business property  
15. Bad debts arising from sales or services  
16. Depreciation and obsolescence (explain in Schedule H, Form 1040)  
17. Repairs (explain in Schedule I, Form 1040)  
18. Depletion of mines, oil and gas wells, timber, etc. (submit schedule)  
19. Amortization of emergency facilities (attach statement)  
20. Other business expenses (explain in Schedule I, Form 1040)  
21. Total of lines 11 to 20  
22. Net profit (or loss) before losses of business property (line 10 less line 21)  
23. Less: Losses of business property (attach statement)  
24. Net profit (or loss) (line 22 less line 23). Enter here and on line 1, Schedule C Summary, page 2, Form 1040

### COMPUTATION OF SELF-EMPLOYMENT TAX (See Instructions on other side)

25. Net earnings (or loss) from self-employment included in line 22, above  
26. Net earnings (or loss) from self-employment from partnerships, joint ventures, etc.  
(from column 10, Schedule K, page 4, Form 1065)  
27. Total net earnings (or loss) from self-employment (lines 25 and 26)  
(If total of net earnings is under \$100, do not make any entries below)  
28. Wages paid to you during the taxable year which were subject to withholding for old-age and survivors  
insurance  
29. Total of lines 27 and 28  
30. Self-employment income subject to tax  
If line 29 is (a) not over \$3,600, enter amount shown on line 27  
(b) over \$3,600—and amount on line 28 is \$3,600 or more, enter "none"  
—and amount on line 28 is under \$3,600 enter difference between  
\$3,600 and amount on line 28  
31. Self-employment tax—2½ percent of amount shown on line 30. Enter tax here and as item 5(B), page 1,  
Form 1040

FILL IN ITEMS BELOW BUT DO NOT DETACH

## Schedules.

160

Marzalie Schlude.

(fol.

Year 1951.

## Partnership Income

Arthur Murray Dance Studio, \$12,605.92

309 South 19th Street

Omaha, Nebraska

54th &amp; University—Woodlawn

Buildings—Loss . . . . . 1,616.53

c/o South Central Realty Co.

216 E. 31st Street

Chicago, Illinois . . . . . \$10,989.39

## Income/(Loss) From Rents

3332 Giles Avenue—Loss . . . . . (\$ 531.64)

7801 South Shore Drive—Loss ( 154.24)

(\$ 685.88)

1305 W. Chicago Avenue—

Income . . . . . 105.25 (\$ 580.63)

3332 Giles Avenue

Rental Income:	417.00
----------------	--------

## Expenses:

Liability Insurance	11.02
---------------------	-------

## Real Estate Taxes

Taxes since date of acquisition:	\$54.23	\$65.25
----------------------------------	---------	---------

Net Loss (Before Depreciation)	(448.25)
--------------------------------	----------

Deduct Depreciation	\$3.39
---------------------	--------

Net Loss	(531.64)
----------	----------

## Depreciation Schedule:

1. Brick House

2. 1941

3. \$730.57 (Includes 1951 additional building cost of \$330.57)

4. \$230.23

5. 500.34

6. 15 years

7. 6 years

8. \$3.39

In 1951, the real estate taxes due against this property since 1928 through 1940 were foreclosed and paid. The total cost was \$550.95 of which \$330.57 was applicable to the cost of the building. In addition, the taxes since the date of acquisition through 1950 were paid in full at a total cost of \$854.23.

(Vol. 74)

Marzalie Schlude ..... 1/2

Harry A. Blossat ..... 1/2

6818 Bennett Ave.  
Chicago, Ill.

## 7801 South Shore Drive

Rent Income: ..... 540.00

## Expenses:

Insurance ..... 35.44

Water ..... 3.66      39.10

Net Income Before depreciation ..... 500.90

A 1/2 interest ..... 250.45

Depreciation—Taxpayer's share ..... 404.69

Net (loss) ..... (154.24)

## Depreciation Schedule:

1. Frame House

2. 12/31/49

3. \$6,067.35

4. 404.69

5. 5,662.66

6. 15 years

7. 14 years

8. 404.69

[fol. 75]

93

Marzalie Schlade—1951

Marzalie Schlade..... 1/2

Bayard W. Biossat..... 2/4

6756 Oglesby Ave.

Chicago, Illinois

Lendol D. Snow..... 1/4

2542 W. 101st St.

Chicago, Illinois

1305 W. Chicago Avenue

Rent Income: ..... 420.00

Expenses:

Management ..... 21.00

Insurance ..... 137.34      158.34

Net Income Before Depreciation ..... 261.66

Depreciation ..... 51.17

Net Income ..... 210.49

1/2 Interest ..... 105.25

Depreciation Schedule:

1. Store and flat

2. 9/18/47

3. \$1,023.72 (includes \$100.00 1951 capital expense)

4. 73.76

5. 949.96

6. 20 years

7. 16 3/4 years

3-51-17



**For Calendar Year 1961**

1951, and ending

1952

### (1) CAPITAL ASSETS

**SHORT-TERM CAPITAL GAINS AND LOSSES: ASSETS HELD NOT MORE THAN 1 YEAR & SALES**

LONG-TERM CAPITAL GAINS AND LOSSES - MOSTLY NEAR THE ZERO THAN IN MONTHS

See attached schedule

(f) Subtract line (e) from line (c) and enter the remainder here. This is your capital loss carry-over to 1952.

**(2) PROPERTY OTHER THAN CAPITAL ASSETS**

See other side for Instructions and Compensation of Arbitration Team

# Schedule of Capital Gains.

Marzalie Schlade.

[fol. 77].

Year 1951.

## One-Fourth Interest in 54th & University—Woodlawn Buildings

Sale of one-fourth interest—

May 1951 .....\$28,480.00

Less Cost Basis—originally ac-

quired April 30, 1949..... 23,569.49

\$4,910.51

## Kreen and Dato Lots

Lots 228, 235, 306, 307, 364 and 366

Sale #1

Sale Price—June 1951.....\$ 2,400.00

Cost—1941 ..... 482.21

\$1,917.79

Less one-half to Joseph Z.

Willner

120 So. LaSalle St.

Chicago, Illinois ..... 958.90

958.90

Sale #2

Sales Price—December, 1951..\$ 350.00

Cost—1941 ..... 79.36

\$ 270.64

Less one-half to Joseph Z.

Willner

120 So. LaSalle St.

Chicago, Illinois .....\$ 135.32

135.32

Total Long-Term Capital Gain

\$6,004.73

## Contributions

\$

\$

Allowable Contributions (not in excess of 15 percent of item 4, page 1)

## Interest

\$

Total Interest

## Taxes

\$

Total Taxes

## Losses from fire, storm, or other casualty, or theft

\$

Total Allowable Losses (not compensated by insurance or otherwise)

## Medical and dental expenses (if over 65 see instructions)

\$

Net Expenses (not compensated by insurance or otherwise)

Enter 5 percent of item 4, page 1, and subtract from Net Expenses

Allowable Medical and Dental Expenses. See Instructions for limitation

\$

## Miscellaneous (See Instructions)

\$

Total Miscellaneous Deductions

Total Deductions

\$

## TAX COMPUTATION FOR CALENDAR YEAR 1981 (For Other Taxable Years Attach Form 1040FY)

1. Enter amount shown in item 4, page 1. This is your Adjusted Gross Income
2. If deductions are itemized above, enter total of such deductions. If deductions are not itemized and line 1, above, is \$5,000 or more: (a) married persons filing separately enter \$500, (b) all others enter 10 percent of line 1, but not more than \$1,000
3. Subtract line 2 from line 1. Enter the difference here. This is your Net Income
4. Multiply \$600 by total number of exemptions claimed in item 1E, page 1. Enter total here
5. Subtract line 4 from line 3. Enter difference here. (If line 1 includes partially tax-exempt interest, see instructions)
6. If line 5 is not more than \$2,000—Enter 20.4 percent of amount on line 5 and disregard lines 7, 8, and 9. This is your normal tax and surtax
7. If line 5 is more than \$2,000 and you are a single person or a married person filing separately—Use tax rates on last page of instructions to figure tax on amount on line 5. This is your normal tax and surtax
8. If line 5 is more than \$2,000 and you are filing a joint return—
  - (a) Enter here one-half of the amount of line 5
  - (b) Use tax rates on last page of instructions to figure tax on amount on line 8(a)
  - (c) Multiply amount on line 8(b) by 2. This is your normal tax and surtax
9. If alternative tax computation is made, enter here tax on back of separate Schedule D
10. Enter here any income tax payments to a foreign country or U. S. possession (attach Form 1116)
11. Enter here any income tax paid at source on tax-free covenant bond interest
12. Add the figures on lines 10 and 11 and enter the total here
13. Subtract line 12 from line 6, 7, 8(c), or 9. Enter difference here and as item 5 (A), page 1. This is your tax

\$ 13,361 13

500 00

\$ 12,861 13

600 00

\$ 12,261 13

\$

\$ 3,583 29

\$

\$

\$

\$

\$ 3,583 29



or taxable year beginning

1952, and ending

195

Name Mark E. Schlude  
(PLEASE PRINT. If this is a joint return of husband and wife, use first names of both)

HOME ADDRESS 452 Beverly Drive  
(PLEASE PRINT. Street and number or rural route)

Omaha 2 Nebraska  
(City, town, or post office) (Postal zone number) (State)

Social Security No. 489-08-3714 Occupation

Do not write in these spaces

703637

(Cashier's Stamp)

REMITTANCE  
MAR 16 1953

41 DED INT 100

Your  
exemptions

1. List your name. If your wife (or husband) had no income, or if this is a joint return, list also her (or his) name.

A. Mark E. Schlude

B.

(Your wife's name—do not list if exemption claimed on another return)

- C. List names of your children (including stepchildren and legally adopted children) with 1952 gross incomes of less than \$600 who received more than one-half of their support from you in 1952. See Instructions.

- D. Enter number of exemptions claimed for close relatives listed in Schedule I on page 2

- E. Enter total number of exemptions claimed in A to D above

2. Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1952, before pay-roll deductions. Persons claiming traveling or reimbursed expenses, see Instructions.

Print Employer's Name

Where Employed (City and State)

Total Wages

Amount Tax Withheld

Enter number of children listed

1

Your  
income

How to  
figure  
the tax

Tax  
due or  
refund

3. If you received dividends, interest, or any other income, give details on page 2 and enter the total here

4. Add income shown in items 2 and 3, and enter the total here

(Before figuring your tax, see Schedule J for "Head of Household." If you claim such status, check here ☐)  
IF YOUR INCOME WAS LESS THAN \$3,000.—Use the tax table on page 4 unless you itemize deductions. The table allows about 10 percent of your income for charitable contributions, interest, taxes, medical expenses, etc. If your deductions exceed 10 percent, it will usually be to your advantage to itemize them and compute your tax on page 3.  
IF YOUR INCOME WAS \$3,000 OR MORE.—Compute tax on page 3. Use standard deduction or itemize deductions, whichever is to your advantage.

5. (A) Enter your tax from table on page 4, or from line 13, page 3

- (B) Enter your self-employment tax from line 35, separate Schedule C

6. How much have you paid on your 1952 income tax?

- (A) By tax withheld (in item 2, above). Attach Original Forms W-2

- (B) By payments on 1952 Declaration of Estimated Tax (include any overpayment on your 1951 tax not claimed as a refund)

7. If your tax (item 5) is larger than payments (item 6), enter balance of tax due here. This balance must be paid in full with return

8. If your payments (item 6) are larger than your tax (item 5), enter the overpayments here

Enter amount of item 8 you want \$

(Refunded)

(Credited on 1953 estimated tax)

Do you owe any prior year Federal tax for which you have been billed? (Yes or No) No Is your wife (or husband) making a separate return for 1952? (Yes or No) Yes If "yes," write her (or his) name Marzalie Schlude

If you have filed a return for a prior year, state latest year 1951 Where filed? Omaha

To which director's (formerly collector's) office did you pay amount claimed in item 6 (B), above? Omaha

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

Robert H. Davis C.F.A.  
(Signature of person, other than taxpayer, preparing this return)

3-14-53  
(Date)

Mark E. Schlude  
(Signature of taxpayer)

March 14, 1953  
(Date)

(Name of firm or employer, if any)

(Signature of taxpayer's wife or husband if this is a joint return)

(Date)

To assure split-income benefits, husband and wife must include all their income and, even though only

15-55504-9

EXHIBIT 10-J

Automatic Canteen  
Corporation  
Trust - Trader

\$ 127.50  
160.00

Enter total here →

\$ 287.50

Name of payor

Schedule B.—INCOME FROM INTEREST  
Amount

Name of payee

Amount

Enter total here →

**Schedule C Summary.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION, FARMING, AND PARTNERSHIP**

1. Business profit (or loss) from separate Schedule C, line 23
2. Farm profit (or loss) from separate schedule, Form 1040F
3. Partnership, etc., profit (or loss) from Form 1065, Schedule K, Column 3  
Arthur Murray Dance Studio, 309 So. 19th St.  
(Partnership name) Omaha, Nebraska
4. Total of lines 1, 2, 3
5. Less: Net operating loss deduction (attach statement)
6. Net profit (or loss) (line 4 less line 5)

\$

18792.16

\$ 18792.16

18792.16

**Schedule D.—NET GAIN OR LOSS FROM SALES OR EXCHANGES OF CAPITAL ASSETS, ETC.**

1. From sale or exchange of capital assets (from separate Schedule D)
2. From sale or exchange of property other than capital assets (from separate Schedule D)

557.67

**Schedule E.—INCOME FROM ANNUITIES OR PENSIONS**

1. Cost of annuity (amount you paid)
2. Cost received tax-free in past years
3. Remainder of cost (line 1 less line 2)
4. Amount received this year
5. Excess of line 4 over line 3
6. Enter line 5, or 3 percent of line 1, whichever is greater (but not more than line 4)

**Schedule F.—INCOME FROM RENTS AND ROYALTIES**

1. Kind and location of property

2. Amount of rent or royalty

3. Depreciation or depletion (explain in Schedule H)

4. Repairs (attach statement)

5. Other expenses (attach statement)

614-616 Woodland Park - See Attached Schedule

610.03

Oil Income - Overide Oil Deal

26.16

1. Totals
2. Net profit (or loss) (column 2 less sum of columns 3, 4, and 5)

**Schedule G.—INCOME FROM ESTATE, TRUSTS AND OTHER SOURCES**

1. Estate or trust
2. Other sources (state nature) (Name) Commissions (Address)
- Total income (or loss) from above sources (Enter here and as item 3, page 1)

524.07

\$ 20657.59

**Schedule H.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULE F**

1. Kind of property (if buildings, state material of which constructed). Exclude land and other nondepreciable property

2. Date acquired

3. Cost or other basis

4. Depreciation allowed (or allowable) in prior years

5. Remaining cost or other basis to be recovered

6. Life used in computing depreciation

7. Estimated life from beginning of year

8. Depreciation allowable this year

**Schedule I.—EXEMPTIONS FOR CLOSE RELATIVES—(See Instructions)**

1. Name of dependent relative. Also give address if different from yours

2. Relationship

(a) Have gross income of \$200 or more?

(b) Resides in your home?

(c) Receive more support from you?

3. If answer to either (b) or (c) is "Yes," enter amount spent for dependent's support in 1957 by—

You (and your wife if this is a joint return)

Others, and by dependent and from own funds

Enter here and as item 1D, page 1, the number of close relatives claimed above

**Schedule J.—HEAD OF HOUSEHOLD (See Instructions)**

(Not applicable where wife or husband died during taxable year)

1. Were you unmarried (or legally separated) at the close of your taxable year? (Yes or No)
2. Did any person for whom you are entitled to an exemption, or your unmarried child, grandchild or stepchild, even though not a dependent, share during your entire taxable year your home which was your principal residence? (Yes or No)  
List name(s) and relationship to you.
3. Did you furnish more than one half of the cost of maintaining the household during the taxable year? (Yes or No)  
If you did not furnish the entire cost, state total amount furnished by you \$ By all others (including those sharing your home) \$
4. If all of the above questions are answered "Yes," you may determine your tax as Head of a Household.

(For Computation of Self-Employment Tax, see Page 3)

For Calendar Year 1952 or taxable year beginning ..... 1952, and ending ..... 195

Name and Address (from Form 1040) Mark E. Schlude, 459 Beverly Drive, Omaha, Nebraska

(Partnerships and joint ventures should file on Form 1065)

(1) Principal business activity (see instructions) Ballroom Dance Instruction

(Retail trade, wholesale trade, law firm, etc.)

(Principal product or service)

(11) Business name Arthur Murray Dance Studio

(III) FICA employer identification number,  
if any (see INSTRUCTIONS) 47-0354832

if any (see INSTRUCTIONS) 47-0354832

(IV) Business address (see instructions) 309 So. 19th St., Omaha

Douglas Nebraska

(Street and number or rural route) (City, town, post office)

(County)

(State)

(V) Were you the sole proprietor of this business in 1952? Yes ☐ , No ☐ . If "No," check whether this business in 1952 became a successor to a corporation ☐ , a partnership ☐ , another sole proprietorship ☐ , or started as an entirely new business ☐ . Where applicable, give name of such predecessor \_\_\_\_\_

**Do NOT include cost of goods withdrawn for personal use or deductions not connected with your business or profession**

1. Total receipts from business or profession

**COST OF GOODS SOLD**

2. Inventory at beginning of year

3. Merchandise bought for manufacture or sale

#### 4. Cost of labor

### 5. Material and supplies

6. Other costs (explain in Schedule C-2)

7. Total of lines 2 to 6

B. Less inventory at end of year

9. Net cost of goods sold (line 7 less line 8)

10. Gross profit (line 1 less line 9)

### OTHER BUSINESS DEDUCTIONS

11. Salaries and wages not included in line 4

12. Rent on business property

### 13. Interest on business indebtedness

#### 14. Taxes on business and business property.

15. Losses of business property (attach statement)

16. Bad debts arising from sales or services

17. Depreciation and obsolescence (explain in Schedule C-1)

18. Repairs (explain in Schedule C-2)

19. Depletion of mines, oil and gas wells, timber, etc. (submit schedule)

20. Amortization of emergency facilities (attach statement)

21. Other business expenses (explain in Schedule C-2)

22. Total of lines 11 to 21

23. Enter net profit (or loss) (line 10 less line 22). Also enter on line 24, page 3, and on line 1, Schedule C Summary, Form 1040.

**Schedule C-1. EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED ON LINE 17**

[illegible]

**Schedule C-2. EXPLANATION OF LINES 6, 11, AND 21**

[illegible]



Name of self-employed person Mark E. Schlude

State nature of business, if any, subject to self-employment tax Ballroom Dance Instruction

24. Net profit (or loss) shown on line 23, page 1

\$

25. Losses of business property shown on line 15, page 1

26. Total of lines 24 and 25

\$

27. Less: Net income (or loss) from excluded services or sources included in line 26

Specify excluded services or sources

28. Net earnings from self-employment (line 26 less line 27)

\$

29. Net earnings (or loss) from self-employment from partnerships, joint ventures, etc. (from column 10, Schedule K, Form 1065)

18792.16

30. Total net earnings (or loss) from self-employment (line 28 plus line 29)

\$ 18792.16

(If total of net earnings is under \$400, do not make any entries below)

31. Maximum amount subject to self-employment tax

\$ 3,600.00

32. Less: Wages paid to you during the taxable year which were subject to withholding for old-age and survivors insurance. (If such wages exceed \$3,600, enter \$3,600)

None

33. Maximum amount subject to self-employment tax after adjustment for wages

\$ 3600.00

34. Self-employment income subject to tax—Line 30 or 33, whichever is smaller

\$ 3600.00

35. Self-employment tax—2½ percent of amount on line 34. Enter here and as item 5 (B), page 1, Form 1040

\$ 81.00

FILL IN ITEMS BELOW BUT DO NOT DETACH

55

(1) CAPITAL ASSETS

2. Enter here the sum of gains or losses or difference between gains and losses shown above. Also enter on line 2, Schedule D, page 2, Form 1040.

[Vol. 80]

Mark E. Schlude

Year 1952.

Rent Income ..... \$10,800.88

## Expenses

Management .....	\$ 529.63	
Lights .....	720.20	
Gas .....	213.94	
Water .....	159.30	
Interest .....	457.72	
Insurance .....	353.66	
Janitor .....	679.58	
Plumbing & boiler .....	412.52	
Carpenter .....	406.60	
Roof & Brick repair .....	376.00	
Social Security .....	3.90	
Real estate taxes .....	330.12	
Electric repair .....	109.50	
Equipment .....	511.57	
Plastering & Decorating ....	169.50	
Coal .....	942.20	
Supplies .....	121.86	
Exterminator .....	36.00	
Ashes .....	167.00	
Legal & trust fees .....	296.50	
Depreciation .....	1,363.44	8,360.74

---

 Net Income ..... \$ 2,440.14
 

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Contributions	Partnership	\$ 89.00	
	Allowable Contributions (not in excess of 20 percent of item 4, page 1)	\$ 89.00	
Interest	Mortgage on Home	\$ 301.48	
	Total Interest	301.48	
Taxes	Personal Property tax	\$ 21.32	
	Total Taxes	21.32	
Losses from fire, storm, or other casualty, or theft		\$	
	Total Allowable Losses (not compensated by insurance, or otherwise)		
Medical and dental expenses (if over \$5 see instructions)		\$	
	Net Expenses (not compensated by insurance or otherwise) Enter 5 percent of item 4, page 1, and subtract from Net Expenses	\$	
Miscellaneous (See instructions)	Allowable Medical and Dental Expenses See Instructions for limitation		
	Total Miscellaneous Deductions	\$	
Total Deductions		\$ 411.30	

TAX COMPUTATION—FOR PERSONS NOT USING TAX TABLE ON PAGE 4

1. Enter amount shown in item 4, page 1. This is your Adjusted Gross Income	\$ 20057.59
2. If deductions are itemized above, enter total of such deductions. If deductions are not itemized and line 1, above, is \$5,000 or more: (a) married persons filing separately enter \$500; (b) all others enter 10 percent of line 1, but not more than \$1,000	411.30
3. Subtract line 2 from line 1. Enter the difference here. This is your Net Income	\$ 20245.79
4. Multiply \$600 by total number of exemptions claimed in item 1E, page 1. Enter total here	600.00
5. Subtract line 4 from line 3. Enter difference here. (If line 1 includes partially tax-exempt interest, see Instructions)	\$ 19645.79
6. Enter 22.2 percent of amount shown on line 5 and disregard lines 7, 8, and 9	\$
7. And you are a single person, a married person filing separately, or a head of household — Single persons and married persons filing separately use Tax Rate Schedule I on page 12 of Instructions to figure tax on amount on line 5; heads of household use Tax Rate Schedule II	\$ 7907.02
8. And you are filing a joint return — (a) Enter one-half of amount on line 5 (b) Use Tax Rate Schedule I on page 12 of Instructions to figure tax on amount on line 8 (a) (c) Multiply amount on line 8 (b) by 2	\$
9. If alternative tax computation is made, enter here tax from separate Schedule D	\$ 7907.02
Disregard lines 10, 11, and 12, and copy on line 13 the same figure you entered on line 8, 7, 8 (c), or 9, unless you used itemized deductions	
10. Enter here any income tax payments to a foreign country or U. S. possession (attach Form 1116)	\$
11. Enter here any income tax paid at source on tax-free covenant bond interest	\$
12. Add the figures on lines 10 and 11 and enter the total here	\$
13. Subtract line 12 from line 6, 7, 8 (c), or 9. Enter difference here and as item 5 (A), page 1	\$ 7907.02



U. S. INDIVIDUAL INCOME TAX RETURN  
FOR CALENDAR YEAR 1952

1952

Name Marzalia Schludo  
(PLEASE PRINT. If this is a joint return of husband and wife, use first names of both)  
HOME ADDRESS 458 Eaverly Drive  
(PLEASE PRINT. Street and number or rural route)  
Omaha Nebraska  
(City, town, or post office) (Postal zone number) (State)  
Social Security No. 321-09-2187 Occupation 47

Do not write in these spaces  
REF 703636  
(Cashier's Stamp)  
REC'D WITH CERTIFICATE  
MAR 16 1953

Your  
exemptions

1. List your name. If your wife (or husband) had no income, or if this is a joint return, list also her (or his) name.

A. Marzalia Schludo

B.

(Your wife's name—do not list if exemption is claimed on another return)

- C. List names of your children (including stepchildren and legally adopted children) with 1952 gross incomes of less than \$600 who received more than one-half of their support from you in 1952. See Instructions.

- D. Enter number of exemptions claimed for close relatives listed in Schedule I on page 2

- E. Enter total number of exemptions claimed in A to D above

2. Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1952, before payroll deductions. Persons claiming traveling or reimbursed expenses, see Instructions.

Post Employer's Name

Where Employed (City and State)

Total Wages

Income Tax Withheld

Enter total →

3. If you received dividends, interest, or any other income, give details on page 2 and enter the total here

4. Add income shown in items 2 and 3, and enter the total here

(Before figuring your tax, see Schedule J for "Head of Household." If you claim such status, check here ☐.)  
IF YOUR INCOME WAS LESS THAN \$1,000—Use the tax table on page 4 unless you itemize deductions. The table allows about 10 percent of your income for charitable contributions, interest, taxes, medical expenses, etc. If your deductions exceed 10 percent, it will usually be to your advantage to itemize them and compute your tax on page 5.  
IF YOUR INCOME WAS \$1,000 OR MORE—Compute tax on page 3. Use standard deduction or itemize deductions, whichever is to your advantage.

5. (A) Enter your tax from table on page 4, or from line 13, page 3

- (B) Enter your self-employment tax from line 35, separate Schedule C

6. How much have you paid on your 1952 income tax?

- (A) By tax withheld (in item 2, above). Attach Original Forms W-2

- (B) By payments on 1952 Declaration of Estimated Tax (include any overpayment on your 1951 tax not claimed as a refund)

7. If your tax (item 5) is larger than payments (item 6), enter balance of tax due here. This balance must be paid in full with return.

8. If your payments (item 6) are larger than your tax (item 5), enter the overpayment here

Enter amount of item 8 you want \$

(Refunded)

(Credited on 1953 estimated tax)

Tax  
due or  
refund

Do you owe any prior year Federal tax for which you have been billed? (Yes or No) No Is your wife (or husband) making a separate return for 1952? (Yes or No) Yes If "yes," write her (or his) name Marzalia Schludo  
If you have filed a return for a prior year, state latest year 1951 Where filed? Omaha  
To which director's (formerly collector's) office did you pay amount claimed in item 6 (B), above? Omaha

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

Signature of person, other than taxpayer, preparing this return

(Date)

Signature of taxpayer

(Date)

(Name of firm or employer, if any)

(Signature of taxpayer's wife or husband, if this is a joint return)

(Date)

To assure split-income benefits, husband and wife must include all their income and, even though

EXHIBIT 11-K

Schedule A.—INCOME FROM DIVIDENDS		Page 2	
Name of corporation or other dividend	Amount	Name of corporation or other dividend	Amount
	\$		\$
		Enter total here →	
		\$	

Schedule B.—INCOME FROM INTEREST	
Name of payer	Amount
	\$
Enter total here →	

**Schedule C Summary.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION, FARMING, AND PARTNERSHIP**

1. Business profit (or loss) from separate Schedule C, line 23	\$
2. Farm profit (or loss) from separate schedule, Form 1040F	
3. Partnership, etc., profit (or loss) from Form 1065, Schedule K, Column 3	1,179.17
4. Total of lines 1, 2, 3	\$1,179.17
5. Less: Net operating loss deduction (attach statement)	
6. Net profit (or loss) (line 4 less line 5)	1,179.17

**Schedule D.—NET GAIN OR LOSS FROM SALES OR EXCHANGES OF CAPITAL ASSETS, ETC.**

1. From sale or exchange of capital assets (from separate Schedule D)	3,594.10
2. From sale or exchange of property other than capital assets (from separate Schedule D)	

**Schedule E.—INCOME FROM ANNUITIES OR PENSIONS**

1. Cost of annuity (amount you paid)	\$	4. Amount received this year	\$
2. Cost received tax-free in past years		5. Excess of line 4 over line 3	
3. Remainder of cost (line 1 less line 2)	\$	6. Enter line 5, or 3 percent of line 1, whichever is greater (but not more than line 4)	

**Schedule F.—INCOME FROM RENTS AND ROYALTIES**

1. Kind and location of property	2. Amount of rent or royalty	3. Depreciation or depletion (include in Schedule H)	4. Royalty (attach statement)	5. Other income (attach statement)	
3332 Rile Ave. — See Attached Schedule	\$	\$	\$	\$	192.64
7101 South Shore Drive — See Attached Schedule	\$	\$	\$	\$	(282.77)
1305 W. Chicago Ave. — See Attached Schedule	\$	\$	\$	\$	(175.44)
Harry A. Blossat — Dec. 1938	\$	\$	\$	\$	(22.62)
1. Totals	\$	\$	\$	\$	
2. Net profit (or loss) (column 2 less sum of columns 3, 4, and 5)					

**Schedule G.—INCOME FROM ESTATES AND TRUSTS AND OTHER SOURCES**

1. Estate or trust Harry A. Blossat, deceased, Chicago, Ill.	2138.61
2. Other sources (state nature)	
Total income (or loss) from above sources (Enter here and as item 3, page 1)	
\$ 24258.09	

**Schedule H.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULE F**

1. Kind of property (if building, state whether of which constructed. Exclude land and other nondepreciable property)	2. Date acquired	3. Cost or other basis	4. Depreciation allowed (or allowable) in prior years	5. Remaining cost or other basis to be reported	6. Life used in computing depreciation	7. Estimated life from beginning of year	8. Depreciation allowable this year
		\$	\$	\$			\$

**Schedule I.—EXEMPTIONS FOR CLOSE RELATIVES—(See Instructions)**

1. Name of dependent relative. Also give address if different from yours	2. Relationship	3. (a) How gross income of 1962 or more?	(b) Death is your home?	(c) Rec'd more support from you?	4. If answer to either (b) or (c) is "Yes" enter amount spent for dependent's support in 1962 by—	5. You (and your wife if this is a joint return)	Others, and by dependent not from you (total)
						\$	\$

Enter here and as item 1D, page 1, the number of close relatives claimed above  

**Schedule J.—HEAD OF HOUSEHOLD (See Instructions)**  
(Not applicable where wife or husband died during taxable year)

1. Were you unmarried (or legally separated) at the close of your taxable year? (Yes or No) 2. Did any person for whom you are entitled to an exemption, or your unmarried child, grandchild, or stepchild, even though not a dependent, share during your entire taxable year your home which was your principal residence? (Yes or No) List name(s) and relationship to you	3. Did you furnish more than one half of the cost of maintaining the household during the taxable year? (Yes or No) If you did not furnish the entire cost, state total amount furnished by you \$ ; by all others (including those sharing your home) \$ 4. If all of the above questions are answered "Yes," you may determine your tax as Head of a Household.
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# **PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION**

**1952**

(For Computation of Self-Employment Tax, see Page 3)

For Calendar Year 1952 or taxable year beginning 1952, and ending 1952

Name and Address (from Form 1040) Murzelie Schlude, 459 Beverly Drive, Omaha, Nebraska

(Partnerships and joint ventures should file on Form 1065)

(I) Principal business activity (see instructions) Ballroom Dancing Instruction

(Retail trade, wholesale trade, lawyer, etc.) (Principal product or service)

(II) Business name Arthur Murray Dance Studio (III) FICA employer identification number 47-0354832

(IV) Business address (see instructions) 300 So. 19th St., Omaha, Douglas, Nebraska

(Street and number or rural route) (City, town, post office) (County) (State)

(V) Were you the sole proprietor of this business in 1951? Yes ☐ No ☐ If "No," check whether this business in 1952 became a successor to a corporation ☐, a partnership ☐, another sole proprietorship ☐, or started as an entirely new business ☐. Where applicable, give name of such predecessor

**Do NOT include cost of goods withdrawn for personal use or deductions not connected with your business or profession**

1. Total receipts from business or profession	\$
<b>COST OF GOODS SOLD</b>	
2. Inventory at beginning of year	\$
3. Merchandise bought for manufacture or sale	
4. Cost of labor	
5. Material and supplies	
6. Other costs (explain in Schedule C-2)	
7. Total of lines 2 to 6	\$
8. Less inventory at end of year	
9. Net cost of goods sold (line 7 less line 8)	
10. Gross profit (line 1 less line 9)	\$
<b>OTHER BUSINESS DEDUCTIONS</b>	
11. Salaries and wages not included in line 4	\$
12. Rent on business property	
13. Interest on business indebtedness	
14. Taxes on business and business property	
15. Losses of business property (attach statement)	
16. Bad debts arising from sales or services	
17. Depreciation and obsolescence (explain in Schedule C-1)	
18. Repairs (explain in Schedule C-2)	
19. Depletion of mines, oil and gas wells, timber, etc. (submit schedule)	
20. Amortization of emergency facilities (attach statement)	
21. Other business expenses (explain in Schedule C-2)	
22. Total of lines 11 to 21	
23. Enter net profit (or loss) (line 10 less line 22). Also enter on line 24, page 3, and on line 1, Schedule C Summary, Form 1040	\$

## **Schedule C-1. EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED ON LINE 17**

1. Kind of property (if buildings, state whether of which depreciated). Exclude land and other nondepreciable property	2. Date acquired	3. Cost or other basis	4. Depreciation allowed (or allowable) in prior years	5. Remaining cost or other basis to be recovered	6. Life used in computing depreciation	7. Estimated life from beginning of year	8. Depreciation allowable this year
		\$	\$	\$			\$

## **Schedule C-2. EXPLANATION OF LINES 6, 18, AND 21**

Line or Column No.	Description	Amount	Line or Column No.	Description	Amount
		\$			\$

**COMPUTATION OF SELF-EMPLOYMENT TAX**  
(For old-age and survivors insurance)

Name of self-employed person Margarette Schlude

State nature of business, if any, subject to self-employment tax Ballroom Dance Instruction

24. Net profit (or loss) shown on line 23, page 1

\$

25. Losses of business property shown on line 15, page 1

26. Total of lines 24 and 25

\$

27. Less: Net income (or loss) from excluded services or sources included in line 26

Specify excluded services or sources

28. Net earnings from self-employment (line 26 less line 27)

\$

29. Net earnings (or loss) from self-employment from partnerships, joint ventures, etc. (from column 10, Schedule K, Form 1065)

18792.17

30. Total net earnings (or loss) from self-employment (line 28 plus line 29)  
(If total of net earnings is under \$400, do not make any entries below)

\$ 18792.17

31. Maximum amount subject to self-employment tax

\$ 3,600.00

32. Less: Wages paid to you during the taxable year which were subject to withholding for old-age and survivors insurance. (If such wages exceed \$3,600, enter \$3,600)

None

33. Maximum amount subject to self-employment tax after adjustment for wages

\$ 3600.00

34. Self-employment income subject to tax—Line 30 or 33, whichever is smaller

\$ 3600.00

35. Self-employment tax—2% percent of amount on line 34. Enter here and as item 5 (B), page 1, Form 1040

\$ 81.00

For Calendar Year 1952 or taxable year beginning

1952, and ending

195

Name and address **Marzelle Sohlude, 450 Beverly Drive, Omaha, Nebraska**

(1) CAPITAL ASSETS

Kind of property and necessary attach statement descriptive details not shown here	2. Date acquired Mo. Day Year	3. Date sold Mo. Day Year	4. Gross sales price (contract price)	5. Depreciation allowed (or otherwise) since ac- quisition or March 1, 1913 (attach schedule)	6. Cost or other basis and cost of subsequent im- provements (if not purchased attach depreciation)	7. Expenses of sale	8. Gain or loss (columns 4 plus column 5 less sum of columns 6 and 7)
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SHORT-TERM CAPITAL GAINS AND LOSSES: ASSETS HELD NOT MORE THAN 6 MONTHS

1. Enter net short-term gain or loss from line 8	\$ 2.03
2. Enter unused capital loss carry-over from 5 preceding taxable years (attach statement)	
3. Enter sum of short-term gains or losses or difference between short-term gains and losses shown above	\$ 2.03

LONG-TERM CAPITAL GAINS AND LOSSES: ASSETS HELD FOR MORE THAN 6 MONTHS

4. <b>Kreon &amp; Dato</b>							
<b>Property</b>	<b>1941 5-52</b>	<b>\$ 9125.00</b>		<b>\$ 4106.55</b>			<b>7018.34</b>
5. Enter the full amount of your share of net long-term gain or loss from partnerships and common trust funds							<b>171.29</b>
6. Enter sum of long-term gains or losses or difference between long-term gains and losses shown above							<b>\$ 7190.23</b>

	Gain or loss to be shown on return	(a) Gain	(b) Loss
8. Enter net short-term gain or loss from line 4	\$ 2.03		
9. Enter net long-term gain or loss from line 7	\$ 7190.23		
Use lines 10 through 13 only if gains exceed losses in lines 8 and 9.			
10. Enter short-term gain (line 8, col. a) reduced by any long-term loss (line 9, col. b)	\$ 2.03		
11. Enter long-term gain (line 9, col. a) reduced by any short-term loss (line 8, col. b)	\$ 7188.20		
12. Enter 50 percent of line 11	\$ 3594.10		
13. Enter here and on line 1, Schedule D, page 2, Form 1040, the sum of lines 10 and 12.	\$ 3594.10		
Use lines 14 and 15 only if losses exceed gains in lines 8 and 9.			
14. Enter the excess of losses over gains on lines 8 and 9			
15. Enter here and on line 1, Schedule D, page 2, Form 1040, the smallest of the following (a) the amount on line 14, (b) net income computed without regard to capital gains and losses, or (c) \$1,000			

COMPUTATION OF ALTERNATIVE TAX

Use only if you had a net long-term capital gain or an excess of net long-term capital gain over net short-term capital loss, and line 5 or 6(a), page 3, Form 1040, exceeds \$14,000

16. Enter from page 3, Form 1040, the income from line 5 if separate return or line 8(a) if joint return	\$ 19992.34
17. Enter amount from line 12, col. a, if separate return or half of such amount if joint return	3594.10
18. Balance (line 16 less line 17)	\$ 16398.24
19. Enter tax on amount on line 18 (use appropriate Tax Rate Schedule in Form 1040 Instructions)	\$ 6039.01
20. If joint return, multiply amount on line 19 by two	\$ 12078.02
21. Enter 52 percent of amount on line 17	\$ 1868.93
22. If joint return, multiply amount on line 21 by two	\$ 3737.86
23. Alternative tax (line 19 plus line 21 if separate return, line 20 plus line 22 if joint return)	\$ 7207.94
24. Enter tax from page 3, Form 1040 (either line 7, or line 8(c), whichever is applicable)	\$ 8111.48
25. Tax liability (line 23 or 24, whichever is smaller). Enter here and also on line 9, page 3, Form 1040	\$ 7207.94

(2) PROPERTY OTHER THAN CAPITAL ASSETS

1. Kind of property	2. Date acquired Mo. Day Year	3. Date sold Mo. Day Year	4. Gross sales price (contract price)	5. Depreciation allowed (or otherwise) since ac- quisition or March 1, 1913 (attach schedule)	6. Cost or other basis and cost of subsequent im- provements (if not purchased attach depreciation)	7. Expenses of sale	8. Gain or loss (column 4 plus column 5 less sum of columns 6 and 7)
1.			\$	\$	\$	\$	\$

2. Enter here the sum of gains or losses or difference between gains and losses shown above. Also enter on line 2, Schedule D, page 2, Form 1040.

Marzalie Schlude. [fol. 81]

Year 1952.

Rental Income ..... \$510.00

## Expenses

Insurance ..... \$ 25.73

Roof &amp; Brick repair ..... 27.50

Real estate taxes ..... 62.54

Plastering &amp; decorating ..... 80.00

Legal &amp; trust fees ..... 10.00

Depreciation ..... 111.39

317.16

Net Income .....\$192.84Marzalie Schlude 100% ..... \$192.84

## Depreciation.

1. Brick House

2. 1941

3. \$70.57

4. \$313.62

5. \$556.95

6. 15 Years

7. 5 Years

8. \$111.39

[fol. 85]

Marzalie Schlude.

L Year 1952.

Rent Income .....		\$530.00
Expenses .....		
Management .....	\$ 26.50	
Insurance .....	132.38	
Plumbing & boiler .....	28.50	
Real estate taxes .....	565.97	
Supplies .....	7.53	
Depreciation .....	120.00	\$850.88

Net Loss .....

---

(850.88)

Marzalie Schlude 50% .....

---

\$175.44

Bayard W. Blossat 25% .....

---

\$5.72

6756 Oglesby Ave.

Chicago, Ill.

Lendol D. Snow 25% .....

---

\$5.72

2542 W. 101st Street

Chicago, Ill.

---

\$350.88

---

### Depreciation.

1. Store & flat

2. 9-18-47

3. \$2,031.23

4. \$ 173.23

5. \$1,858.00

6. 20 Years

7. 15 1/2 Years

8. \$ 120.00

---



(fol: 86)

Marzalie Schlude

Year 1952

Rent Income ..... \$643.50

## Expenses

Management ..... \$ 35.00

Water ..... 12.00

Insurance ..... 12.12

Plumbing &amp; boiler ..... 7.50

Real estate taxes ..... 333.05 399.67

Net Income Before Depreciation ..... \$243.83

Marzalie Schlude 50% ..... \$121.92

Harry A. Blossat 50% ..... 121.91

6818 Bennett Ave.

Chicago, Ill.

\$243.83

Marzalie Schlude ..... \$121.92

Depreciation—Taxpayers share ..... 404.69

Net Loss ..... \$282.77

## Depreciation.

1. Frame House

2. 12-31-49

3. \$6,067.34

4. \$5,257.97

5. \$ 809.38

6. 15 Years

7. 13 Years

8. \$ 404.69

Contributions	Church	\$	25.00
	Partnership	\$	89.00
Allowable Contributions (not in excess of 20 percent of item 4, page 1)		\$	114.00
Interest	Mortgage on home	\$	301.47
	Total Interest		301.47
Taxes	Proportionate share of real estate taxes paid through estate of Mary A. Blossut deceased	\$	3228.90
	Personal Property tax		21.32
	Total Taxes		3250.22
Losses from fire, storm, or other casualty, or theft		\$	
Total Allowable Losses (not compensated by insurance or otherwise)			
Medical and dental expenses (if over 65 see Instructions)		\$	
	Net Expenses (not compensated by insurance or otherwise)	\$	
Enter 5 percent of item 4, page 1, and subtract from Net Expenses			
Allowable Medical and Dental Expenses See Instructions for limitation			
Miscellaneous (See Instructions)		\$	
	Total Miscellaneous Deductions		
Total Deductions		\$	3665.75

TAX COMPUTATION—FOR PERSONS NOT USING TAX TABLE ON PAGE 4

1. Enter amount shown in item 4, page 1. This is your Adjusted Gross Income	\$	24258.02
2. If deductions are itemized above, enter total of such deductions. If deductions are not itemized and line 1, above, is \$5,000 or more: (a) married persons filing separately enter \$500, (b) all others enter 10 percent of line 1, but not more than \$1,000	\$	3665.75
3. Subtract line 2 from line 1. Enter the difference here. This is your Net Income	\$	20592.27
4. Multiply \$600 by total number of exemptions claimed in item 1E, page 1. Enter total here	\$	600.00
5. Subtract line 4 from line 3. Enter difference here. (If line 1 includes partially tax-exempt interest, see Instructions)	\$	19992.27
If line 5 is not more than \$2,000 ———		
6. Enter 22.2 percent of amount shown on line 5 and disregard lines 7, 8, and 9	\$	
If line 5 is more than \$2,000 ———		
7. And you are a single person, a married person filing separately, or a head of household ———	\$	8111.48
Single persons and married persons filing separately use Tax Rate Schedule I on page 12 of Instructions to figure tax on amount on line 5, heads of household use Tax Rate Schedule II		
8. And you are filing a joint return ———	\$	
(a) Enter one-half of amount on line 5	\$	
(b) Use Tax Rate Schedule I on page 12 of Instructions to figure tax on amount on line 8 (a)	\$	
(c) Multiply amount on line 8 (b) by 2	\$	
9. If alternative tax computation is made, enter here tax from separate Schedule D	\$	7907.84
Disregard lines 10, 11, and 12, and copy on line 13 the same figure you entered on line 8, 7, 8 (c), or 9, unless you used itemized deductions		
10. Enter here any income tax payments to a foreign country or U. S. possession (attach Form 1116)	\$	
11. Enter here any income tax paid at source on tax-free covenant bond interest	\$	
12. Add the figures on lines 10 and 11 and enter the total here	\$	
13. Subtract line 12 from line 6, 7, 8 (c), or 9. Enter difference here and as item 5 (A), page 1	\$	7907.84

# U. S. INDIVIDUAL INCOME TAX RETURN

## FOR CALENDAR YEAR 1953

1953

or taxable year beginning 1953, and ending 1953

Do not write in these spaces

Name L. AND ARZALIE SCHULTE  
(PLEASE PRINT. If this is a joint return of husband and wife, use first names of both)

1020221

(Custodian's Stamp)

HOME ADDRESS 459 BLVD. DRIVE  
(PLEASE PRINT. Street and number or rural route)

OMAHA

NEBRASKA

(City, town, or post office)

(Postal zone number)

(State)

Social Security No. 321-09-3164

Occupation

1. List your name. If your wife (or husband) had no income, or if this is a joint return, list also her (or his) name.

A. MARK E. SCHULTE

B. ARZALIE SCHULTE

- C. List names of your children (including stepchildren and legally adopted children) with 1953 gross incomes of less than \$600 who received more than one-half of their support from you in 1953. See Instructions.

- D. Enter number of exemptions claimed for other close relatives listed in Schedule I on page 2

- E. Enter total number of exemptions claimed in A to D above

2. Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1953, before pay-roll deductions. Persons claiming traveling or reimbursed expenses, see Instructions.

Employer's Name

Where Employed (City and State)

Total Wages

Income Tax Withheld

3. If you received dividends, interest, or any other income (or loss), give details on page 2 and enter the total here

4. Add amounts shown in items 2 and 3, and enter the total here

(Unmarried or legally separated persons qualifying under Schedule J as "Head of Household," check here ☐)  
IF YOUR INCOME WAS LESS THAN \$1,000.—Use the tax table on page 4 unless you itemize deductions. The table allows about 10 percent of your income for charitable contributions, interest, taxes, medical expenses, etc. If your deductions exceed 10 percent, it will usually be to your advantage to itemize them and compute your tax on page 3.  
IF YOUR INCOME WAS \$1,000 OR MORE.—Compute tax on page 3. Use standard deduction or itemize deductions, whichever is to your advantage.

5. (A) Enter your tax from table on page 4, or from line 13, page 3

- (B) Enter your self-employment tax from line 35, separate Schedule C

6. How much have you paid on your 1953 income tax?

- (A) By tax withheld (in item 2, above). Attach Original Forms W-2

- (B) By payments on 1953 Declaration of Estimated Tax (include any overpayment on your 1952 tax not claimed as a refund)

7. If your tax (item 5) is larger than payments (item 6), enter balance of tax due here. This balance must be paid in full with return

8. If your payments (item 6) are larger than your tax (item 5), enter the overpayment here

Enter amount of item 8 you want \$

(Credited on 1954 estimated tax)

(Refunded)

Do you owe any prior year Federal tax for which you have been billed? (Yes or No) No Is your wife (or husband) making a separate return for 1953? (Yes or No) No If "yes," write her (or his) name

If you have filed a return for a prior year, state latest year 19 52 Where filed? Omaha

To which District Director's office did you pay amount claimed in item 6 (B), above? Omaha

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

(Signature of preparer, other than taxpayer, preparing this return)

(Date)

(Signature of taxpayer)

(Date)

Robert L. Davis - Certified Public

Arzalie Schulte

3/2/54

(Name of firm or company, if any)

(Signature of taxpayer's wife or husband if this is a joint return)

(Date)

(If married, attach separate schedule for each spouse if their income was over \$1,000 each, even though only one spouse is required to file a return)

Omaha, Nebraska

EXHIBIT 12-L

EXHIBIT 12-L TO REGULATION OF FACTS



Schedule A.—INCOME FROM DIVIDENDS		Schedule B.—INCOME FROM INTEREST	
Name of corporation owning dividend	Amount	Name of payer	Amount
	\$		\$
Enter total here →		Enter total here →	
\$		\$	

Schedule C Summary.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION, FARMING, AND PARTNERSHIP	
1. Business profit (or loss) from separate Schedule C, line 23	\$
2. Farm profit (or loss) from separate schedule, Form 1040F	
3. Partnership, etc., profit (or loss) from Form 1065, Schedule K, Column 3	
4. Total of lines 1, 2, 3 (Partnership name) (Address)	\$
5. Less: Net operating loss deduction (attach statement)	
6. Net profit (or loss) (line 4 less line 5)	

Schedule D.—NET GAIN OR LOSS FROM SALES OR EXCHANGES OF CAPITAL ASSETS, ETC.	
1. From sale or exchange of capital assets (from separate Schedule D)	
2. From sale or exchange of property other than capital assets (from separate Schedule D)	

Schedule E.—INCOME FROM ANNUITIES OR PENSIONS	
1. Cost of annuity (amount you paid)	\$
2. Cost received tax-free in past years	
3. Remainder of cost (line 1 less line 2)	\$
4. Amount received this year	\$
5. Excess of line 4 over line 3	
6. Enter line 5, or 3 percent of line 1, whichever is greater (but not more than line 4)	

Schedule F.—INCOME FROM RENTS AND ROYALTIES				
1. Kind and location of property	2. Amount of rent or royalty	3. Depreciation or depletion (attach to Schedule H)	4. Repairs (attach itemized list)	5. Other expenses (attach itemized list)
	\$	\$	\$	\$
1. Totals	\$	\$	\$	\$
2. Net profit (or loss) (column 2 less sum of columns 3, 4, and 5)				

Schedule G.—INCOME FROM OTHER SOURCES INCLUDING ESTATES AND TRUSTS	
1. Estate or trust (Name) (Address)	
2. Other sources (state nature)	SEE A TACHED SCHEDULE
Total income (or loss) from above sources (Enter here and as item 3, page 1)	\$ 222.49

Schedule H.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULE F							
1. Kind of property (if buildings, state whether of which constructed; if other, state and other depreciable property)	2. Date acquired	3. Cost or other basis	4. Depreciation allowed (or allowable) in prior years	5. Remaining cost or other basis to be recovered	6. If used in accumulating depreciation	7. Estimated life from beginning of year	8. Depreciation allowable this year
		\$	\$	\$			\$

Schedule I.—EXEMPTIONS FOR CLOSE RELATIVES OTHER THAN WIFE AND CHILDREN—(See instructions)						
1. Name of dependent relative. Also give address if different from yours	2. Relationship	3. Have gross income of \$200 or more?	4. Reside in your home?	5. Receive more support than you?	6. If answer to either (3), (4), or (5) is "No," enter amount paid for dependent's support in 1953 by—	7. You (and your wife if due to a joint return) Others, and 2. If you are to be determined without reference to this schedule
						\$
						\$
						\$

Enter here and as item 1D, page 1, the number of other close relatives claimed above

Schedule J.—HEAD OF HOUSEHOLD (See instructions)	
(Not applicable where wife or husband died during taxable year)	
<p>If all of the following questions are answered "Yes," you may determine your tax as Head of a Household.</p> <p>1. Were you unmarried (or legally separated) at the close of your taxable year? (Yes or No)</p> <p>2. Was your home occupied during the entire taxable year as the principal residence of both yourself and (a) a person for whom you are entitled to an exemption, or (b) your unmarried child, grandchild, or stepchild, even though not a dependent? (Yes or No)</p>	<p>List name(s) and relationship to you</p> <p>3. Did you furnish more than one-half of the cost of maintaining the household during the taxable year? (Yes or No)</p> <p>If you did not furnish the entire cost, state total amount furnished by you \$ by all others (including those sharing your home) \$ Deductions in part 3 are to be determined without reference to this schedule.</p>

# **PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION**

**1953**

(For Computation of Self-Employment Tax, see Page 2)

For Calendar Year 1953 or taxable year beginning \_\_\_\_\_, 1953, and ending \_\_\_\_\_, 1953

Name and Address (from Form 1040) ARTHUR E. SCHLUDE - 459 BEVERLY DRIVE - OMAHA, NEBR.

(Partnerships and joint ventures should file on Form 1065)

(I) Principal business activity (see instructions) BALLROOM DANCING INSTRUCTION  
(Retail trade, wholesale trade, lawyer, etc.) (Principal product or service)

(II) Business name ARTHUR E. SCHLUDE STUDIO (III) Number of places of business 5

(IV) FICA employer identification number, if any (see instructions) 47-035 - 4832

(V) Business address (see instructions) 309 SOUTH 19th STREET, OMAHA (City, town, post office) (Country) (State)  
NEBRASKA

(VI) Were you the sole proprietor of this business in 1952? Yes ☐ No ☒ If "No," check whether this business in 1953 became a successor to a corporation ☐, a partnership ☐, another sole proprietorship ☐, or started as an entirely new business ☐ Where applicable, give name of such predecessor

Do NOT include cost of goods withdrawn for personal use or deductions not connected with your business or profession

1. Total receipts from business or profession \$

## **COST OF GOODS SOLD**

2. Inventory at beginning of year \$

3. Merchandise bought for manufacture or sale

4. Cost of labor

5. Material and supplies

6. Other costs (explain in Schedule C-2)

7. Total of lines 2 to 6 \$

8. Less inventory at end of year

9. Net cost of goods sold (line 7 less line 8)

10. Gross profit (line 1 less line 9) \$

## **OTHER BUSINESS DEDUCTIONS**

11. Salaries and wages not included in line 4 \$

12. Rent on business property

13. Interest on business indebtedness

14. Taxes on business and business property

15. Losses of business property (attach statement)

16. Bad debts arising from sales or services

17. Depreciation and obsolescence (explain in Schedule C-1)

18. Repairs (explain in Schedule C-2)

19. Depletion of mines, oil and gas wells, timber, etc. (submit schedule)

20. Amortization of emergency and grain storage facilities (attach statement)

21. Other business expenses (explain in Schedule C-2)

22. Total of lines 11 to 21

23. Enter net profit (or loss) (line 10 less line 22) Also enter on line 24, page 3, and on line 1, Schedule G Summary, Form 1040 \$

### **Schedule C-1. EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED ON LINE 17**

1. Kind of property (if buildings, state material of which constructed). Exclude land and other nondepreciable property	2. Date acquired	3. Cost to owner	4. Depreciation allowed (or allowable) in prior years	5. Remaining cost of other basis to be recovered	6. Life used in computing depreciation	7. Estimated life from beginning of year	8. Depreciation allowable this year
		\$	\$	\$			\$

### **Schedule C-2. EXPLANATION OF LINES 6, 18, AND 21**

Line or Column No.	Description	Amount	Line or Column No.	Description	Amount
		\$			\$



Name of self-employed person THE E. SCHLUDT

State nature of business, if any, subject to self-employment tax RETAIL MERCHANDISE

24 Net profit (or loss) shown on line 23, page 1

\$

25 Losses of business property shown on line 15, page 1

26 Total of lines 24 and 25

\$

27 Less: Net income (or loss) from excluded services or sources included in line 26  
Specify excluded services or sources

28 Net earnings from self-employment (line 26 less line 27)

\$

29 Net earnings (or loss) from self-employment from partnerships, joint ventures, etc. (from column 10, Schedule K, Form 1065)

30 Total net earnings (or loss) from self-employment (line 28 plus line 29)  
(If total of net earnings is under \$400, do not make any entries below)

\$

31 Maximum amount subject to self-employment tax

\$ 3,600.00

32 Less: Wages paid to you during the taxable year which were subject to withholding for old-age and survivors insurance. (If such wages exceed \$3,600, enter \$3,600)

33 Maximum amount subject to self-employment tax after adjustment for wages

\$ 3,517

34 Self-employment income subject to tax—Line 30 or 33, whichever is smaller

\$

35 Self-employment tax—2% percent of amount on line 34. Enter here and as item 5(B), page 1, Form 1040

\$

# **PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION**

**1953**

(For Computation of Self-Employment Tax, see Page 3)

For Calendar Year 1953 or taxable year beginning ....., 1953, and ending ....., 1953.

Name and Address (from Form 1040) MARZALIE SCHULDE - 459 BEVERLY DRIVE - OMAHA, NEBR.

(Partnerships and joint ventures should file on Form 1065)

(I) Principal business activity (see instructions) BALLET DANCING INSTRUCTION  
(Retail trade, wholesale trade, lawyer, etc.) (Principal product or service)

(II) Business name ARTHUR URRAY DANCE STUDIO (III) Number of places of business 5

(IV) FICA employee identification number, if any (see instructions) 47-035-4832

(V) Business address (see instructions) 309 SOUTH 19th STREET OMAHA NEBRASKA  
(Street and number or rural route) (City, town, post office) (County) (State)

(VI) Were you the sole proprietor of this business in 1953? Yes ☐ No ☒ If "No," check whether this business in 1953 became a successor to a corporation ☐, a partnership ☐, another sole proprietorship ☐, or started as an entirely new business ☐. Where applicable, give name of such predecessor

Do NOT include cost of goods withdrawn for personal use or deductions not connected with your business or profession

1. Total receipts from business or profession

## **COST OF GOODS SOLD**

2. Inventory at beginning of year

3. Merchandise bought for manufacture or sale

4. Cost of labor

5. Material and supplies

6. Other costs (explain in Schedule C-2)

7. Total of lines 2 to 6

8. Less inventory at end of year

9. Net cost of goods sold (line 7 less line 8)

10. Gross profit (line 1 less line 9)

## **OTHER BUSINESS DEDUCTIONS**

11. Salaries and wages not included in line 4

12. Rent on business property

13. Interest on business indebtedness

14. Taxes on business and business property

15. Losses of business property (attach statement)

16. Bad debts arising from sales or services

17. Depreciation and obsolescence (explain in Schedule C-1)

18. Repairs (explain in Schedule C-2)

19. Depletion of mines, oil and gas wells, timber, etc. (submit schedule)

20. Amortization of emergency and grain storage facilities (attach statement)

21. Other business expenses (explain in Schedule C-2)

22. Total of lines 11 to 21

23. Enter net profit (or loss) (line 10 less line 22). Also enter on line 24, page 3, and on line 1,

Schedule C Summary, Form 1040

### **Schedule C-1 EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED ON LINE 17**

1. Kind of property (if buildings, state whether of stock ownership). Excludes land and other nondepreciable property	2. Date acquired	3. Cost or other basis	4. Depreciation allowed (or allowable) in prior years	5. Remaining cost or other basis to be depreciated	6. Life used in computing depreciation	7. Estimated % from beginning of year	8. Depreciation deduction for this year
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		\$	\$	\$		\$	\$
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### **Schedule C-2 EXPLANATION OF LINES 6, 12, AND 21**

Line or Column No.	Description	Amount	Line or Column No.	Description	Amount
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**COMPUTATION OF SELF-EMPLOYMENT TAX**  
(For old-age and survivors insurance)

Name of self-employed person MARZALIE SCHLUDE

State nature of business, if any, subject to self-employment tax BALLROOM DANCING INSTRUCTION

24. Net profit (or loss) shown on line 23, page 1	\$		
25. Losses of business property shown on line 15, page 1			
26. Total of lines 24 and 25	\$		
27. Less: Net income (or loss) from excluded services or sources included in line 26 Specify excluded services or sources			
28. Net earnings <sup>2</sup> from self-employment (line 26 less line 27)	\$		
29. Net earnings (or loss) from self-employment from partnerships, joint ventures, etc. (from column 10, Schedule K, Form 1065)		25,398	18
30. Total net earnings (or loss) from self-employment (line 28 plus line 29) (If total of net earnings is under \$400, do not make any entries below)	\$	25,398	18
31. Maximum amount subject to self-employment tax	\$	3,600	00
32. Less: Wages paid to you during the taxable year which were subject to withholding for old-age and survivors insurance. (If such wages exceed \$3,600, enter \$3,600)			
33. Maximum amount subject to self-employment tax after adjustment for wages	\$	3,600	00
34. Self-employment income subject to tax—Line 30 or 33, whichever is smaller	\$	3,600	00
35. Self-employment tax—2% percent of amount on line 34. Enter here and as item 5 (B), page 1, Form 1040	\$	81	00

7801 South Shore Drive.

[fol. 89]

Mark and Marzalie Schlude.

Year 1953.

Income .....	\$ 734.50
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## Expenses

Management .....	\$ 35.00
Water .....	11.80
Insurance .....	49.38
	<u>96.18</u>

Net Profit .....	\$ 638.32
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Taxpayer's share 50% .....	\$ 319.16
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Less Depreciation .....	404.69
	<u>          </u>

Net Loss .....	\$ 85.53
	<u>          </u>

## Taxpayers Depreciation

Date Acquired .....	12/31/49
---------------------	----------

Estimate Life .....	15 Yrs.
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Cost .....	\$ 6,067.35
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Depreciation 1953 .....	\$ 404.69
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Mark and Marzalia Schlude.

[fol. 90]

Year 1953.

Income ..... \$ 504.00

Expenses

Insurance ..... \$ 20.79

Carpenter ..... 76.00

Real Estate Taxes ..... 68.70

Plastering and Decorating ..... 250.00

Depreciation ..... 141.39

526.88

Loss

\$ 22.88

Depreciation

Date Acquired ..... 1941

Estimated Life ..... 15 Yr.

Remaining Life ..... 4 Yr.

Cost ..... \$ 870.57

Depreciation 1953 ..... \$ 111.39

Depreciation Accumulated to 12/31/52 ..... \$ 425.01



614-16 Woodland Park.

[fol. 91]

Mark and Marzalie Schlude.

Year 1953.

Income ..... \$12,931.45

## Expenses

Management .....	\$ 628.15	
Light .....	910.81	
Gas .....	470.74	
Water .....	209.70	
Interest .....	336.01	
Insurance .....	230.33	
Janitor .....	557.50	
Plumbing and Heating .....	390.68	
Carpenter .....	316.93	
Roof Gutter and Brick .....	400.00	
Social Security Taxes .....	8.55	
Real Estate Taxes .....	330.12	
Electric Repairs .....	41.25	
Equipment .....	141.85	
Plastering and Decorating ..	474.00	
Coal .....	931.90	
Supplies .....	88.28	
Exterminator .....	36.00	
Ashes .....	109.50	
Legal .....	301.50	
Depreciation .....	1,363.44	8,277.24
		<u>\$ 4,654.21</u>
		<u><u>\$ 1,163.55</u></u>

Taxpayers Share—25% .....

## Depreciation

Date Acquired .....	12/4/51
Estimated Life .....	20 Yrs.
Remaining Life .....	18 Yrs.- 11 Mo.
Cost .....	\$27,261.93
Depreciation .....	\$ 1,363.44

1305 Chicago Avenue.

123

Mark and Marzalie Schlude.

[fol. 92]

Year 1953.

Income ..... \$ 670.00

Expenses

Management .....	\$ 32.50	
Insurance.....	160.23	
Plumbing and Heating .....	94.25	
Roof Gutter and Brick .....	108.35	
Real Estate Taxes .....	137.46	
Legal Service .....	10.00	
Depreciation .....	134.88	678.67

Net Loss ..... \$ 8.67

Taxpayers Share 50% ..... \$ 4.34

Depreciation

Date Acquired .....	9/18/47.
Estimated Life .....	20 Yrs.
Remaining Life .....	14½ Yrs.
Cost .....	\$ 2,250.33
Depreciation .....	\$ 134.88

## Summary of Taxable Income.

[fol. 93]

Mark E. and Marzalie Schlude.

Year 1953.

## Partnership Income

Mark E. Schlude .....	\$25,398.18	
Marzalie Schlude .....	25,398.18	\$50,796.36

Estate of Harry A. Biossat—Deceased.....		539.19
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The Harry A. Biossatt Family Liquidation Trust Loss .....	( 1,250.75)	
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Oil Income—Override Oil Deal.....		19.08
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Dividends—Traux-Traer Common Stock...		100.00
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## Income (Loss) From Rental Properties—Chicago

614-16 Woodland .....	\$ 1,163.55	
3332 Giles .....	( 22.88)	
7801 South Shore Drive....	( 85.53)	
1305 Chicago .....	( 4.34)	1,050.80

Ordinary Income .....		\$51,254.68
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Capital Gains .....		8,068.71
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\$59,323.39

Less Interest Charged on Marginal Account		100.90
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\$59,222.49

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Name and address MARK AND MARZALIE SCHLUDT, 452 HAVELLY DRIVE - OLAH, ALA.

(1) CAPITAL ASSETS

1. Kind of property (if necessary, attach statement of description, date, and amount)	2. Date acquired Mo. Day Year	3. Date sold Mo. Day Year	4. Gross sales price (net of price)	5. Depreciation allowed (or otherwise) since ac- quisition or March 1, 1913 (attach schedule)	6. Cost or other basis and cost of subsequent im- provements (if not purchased, attach explanation)	7. Expenses of sale	8. Gain or loss (column 4 plus column 5 less sum of columns 6 and 7)
<b>SHORT-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD NOT MORE THAN 6 MONTHS</b>							
1. Enter your share of net short-term gain or loss from partnerships and common trust funds			\$	\$	\$	\$	\$
2. Enter unused capital loss carry-over from 5 preceding taxable years (attach statement)							
3. Enter sum of short-term gains or losses or difference between short-term gains and losses shown above							\$
<b>LONG-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR MORE THAN 6 MONTHS</b>							
4. Enter the full amount of your share of net long-term gain or loss from partnerships and common trust funds			\$	\$	\$	\$	\$
5. Enter sum of long-term gains or losses or difference between long-term gains and losses shown above							\$16137 42

	Gain or loss to be taken into account	
	(a) Gain	(b) Loss
8. Enter net short-term gain or loss from line 4	\$16137 42	\$
9. Enter net long-term gain or loss from line 7	\$	\$
10. Enter short-term gain (line 8, col. a) reduced by any long-term loss (line 9, col. b)	\$16137 42	XXXXX
11. Enter long-term gain (line 9, col. a) reduced by any short-term loss (line 8, col. b)	\$9008 71	XXXXX
12. Enter 50 percent of line 11	\$4504 35	XXXXX
13. Enter here and on line 1, Schedule D, page 2, Form 1040, the sum of lines 10 and 12	\$20641 77	XXXXX
14. Enter the excess of losses over gains on lines 8 and 9	XXXXX	\$
15. Enter here and on line 1, Schedule D, page 2, Form 1040, the smallest of the following: (a) the amount on line 14; (b) net income computed without regard to capital gains and losses; or (c) \$1,000	XXXXX	\$

COMPUTATION OF ALTERNATIVE TAX FOR CALENDAR YEAR 1953

Use only if you had a net long-term capital gain or an excess of net long-term capital gain over net short-term capital loss, and line 5 or 9(a), page 3, Form 1040, exceeds \$14,000

16. Enter from page 3, Form 1040, the income from line 5 if separate return or line 8 (a) if joint return	\$28,511 75
17. Enter amount from line 12, column (a), if separate return or half of such amount (if joint return)	\$14,255 87
18. Balance (line 16 less line 17)	\$14,255 87
19. Enter tax on amount on line 18 (use appropriate Tax Rate Schedule in Form 1040 Instructions)	\$2,097 80
20. If joint return, multiply amount on line 19 by two	\$4,195 72
21. Enter 52 percent of line 17	\$7,412 99
22. If joint return, multiply amount on line 21 by two	\$14,825 98
23. Alternative tax (line 19 plus line 21 if separate return; line 20 plus line 22 if joint return)	\$29,081 70
24. Enter tax from page 3, Form 1040 (either line 7, or line 8 (c), whichever is applicable)	\$27,177 22
25. Tax liability (line 23 or 24, whichever is smaller). Enter here and also on line 9, page 3, Form 1040	\$27,177 22

(2) PROPERTY OTHER THAN CAPITAL ASSETS

1. Kind of property	2. Date acquired Mo. Day Year	3. Date sold Mo. Day Year	4. Gross sales price (net of price)	5. Depreciation allowed (or otherwise) since ac- quisition or March 1, 1913 (attach schedule)	6. Cost or other basis and cost of subsequent im- provements (if not purchased, attach explanation)	7. Expenses of sale	8. Gain or loss (column 4 plus column 5 less sum of columns 6 and 7)
1. Enter here the sum of gains or losses or difference between gains and losses shown above. Also enter on line 2, Schedule D, page 2, Form 1040			\$	\$	\$	\$	\$



<b>Contributions</b>		\$	
	Total Contributions (not more than 20 percent of item 4, page 1)	\$	
<b>Interest</b>		\$	
	Total Interest	\$	
<b>Taxes</b>		\$	
	Total Taxes	\$	
<b>Losses from fire, storm, or other casualty, or theft</b>		\$	
	Total Allowable Losses (not compensated by insurance or otherwise)	\$	
<b>Medical and dental expenses (if over \$5 see Instructions)</b>		\$	
	Net Expenses (not compensated by insurance or otherwise)	\$	
	Enter 5 percent of item 4, page 1; subtract from Net Expenses	\$	
	Allowable Medical and Dental Expenses. See Instructions for limitation	\$	
<b>Miscellaneous (See Instructions)</b>		\$	
	Total Miscellaneous Deductions	\$	
	Total Deductions	\$	

TAX COMPUTATION FOR CALENDAR YEAR 2008 (For Other Taxable Years Attach Form 100 FT)

1. Enter amount shown in item 4, page 1. This is your Adjusted Gross Income	\$	59,222	49
2. If deductions are itemized above, enter total of such deductions. If deductions are not itemized and line 1, above, is \$5,000 or more: (a) married persons filing separately enter \$500, (b) all others enter 10 percent of line 1, but not more than \$1,000		1,000	00
3. Subtract line 2 from line 1. Enter the difference here. This is your Net Income	\$	58,222	49
4. Multiply \$600 by total number of exemptions claimed in item 1E, page 1. Enter total here		1,200	00
5. Subtract line 4 from line 3. Enter difference here. (If line 1 includes partially tax-exempt interest, see Instructions)	\$	57,022	49
If line 5 is not more than \$2,000 —			
6. Enter 22.2 percent of amount shown on line 5 and disregard lines 7, 8, and 9	\$		
If line 5 is more than \$2,000 —			
7. And you are a single person, a married person filing separately, or a head of household — Single persons and married persons filing separately use Tax Rate Schedule I on page 12 of Instructions to figure tax on amount on line 5; heads of household use Tax Rate Schedule II			
8. And you are filing a joint return —			
(a) Enter one-half of amount on line 5	\$	28,511	25
(b) Use Tax Rate Schedule I on page 12 of Instructions to figure tax on amount on line 8 (a)		13,678	54
(c) Multiply amount on line 8 (b) by 2	\$	27,357	08
9. If alternative tax computation is made, enter here tax from separate Schedule D	\$	20,177	22
Disregard lines 10, 11, and 12, and copy on line 13 the same figure you entered on line 8, 7, 8 (c), or 9, unless you used limited deductions			
10. Enter here any income tax payments to a foreign country or U.S. possession (attach Form 1116)	\$		
11. Enter here any income tax paid at source on tax-free covenant bond interest	\$		
12. Add the figures on lines 10 and 11 and enter the total here	\$		
13. Subtract line 12 from line 6, 7, 8 (c), or 9. Enter difference here and as item 5 (A), page 1	\$	26,177	22



or other taxable year beginning  
FOR CALENDAR YEAR 1954  
1954, and ending  
1955

PLEASE TYPE OR PRINT PLAINLY

Name: MARK E. AND MARZALIE SCHLUDE

Address: 459 Beverly Drive  
City, town, or post office: OMAHA, NEBRASKA

Your Social Security No. and Occupation: 409-09-3714

Wife's (husband's) S. S. No. and Occupation: 321-09-2167

1954

Do not write in these spaces

Serial: 10000048  
(Cashier's Stamp)

APR 1 1955

U. S. INDIVIDUAL  
INCOME TAX  
RETURN

ATTACH TAX RETURN COPIES OF FORMS W-2 HERE

Your  
exemptions

1. List your name. If your wife (or husband) had no income or if this is a joint return, list also her (or his) name:  
A. Mark E. Schlude  
B. Marzalie Schlude  
(Your wife's name—do not list if she is filing a separate return or if she had income not included in this return)

2. List names of your children who qualify as dependents; give address if different from yours.

3. Enter number of exemptions claimed for other individuals listed in Schedule I on page 2.

4. Enter total number of exemptions claimed in A to D above.

Check below if at the end of your taxable year you or your wife were—  
65 or over ☐ Blind ☐  
65 or over ☐ Blind ☐

On lines A and B enter—  
If neither 65 nor blind with the figure 1  
If either 65 or blind with the figure 2  
If both 65 and blind with the figure 3

Number of exemptions for you: 1  
Number of her (or his) exemptions: 1

Enter number of children listed: 2

Your  
income

2. Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1954, before payroll deductions. Persons claiming traveling, transportation, or reimbursed expenses, and Outside Salesmen, see instructions.

A. Employer's Name: \_\_\_\_\_ B. Where Employed (City and State): \_\_\_\_\_ C. Total Wages, Etc.: \$ \_\_\_\_\_ D. Income Tax Withheld: \$ \_\_\_\_\_

3. Less excludable portion received under wage continuation plans for sickness or injury. (See instructions) Enter totals here: \$ \_\_\_\_\_

4. Balance (item 2 less item 3): \$ \_\_\_\_\_

5. If you received dividends, interest, or any other income (or loss), give details on page 2. Enter total here: \$ 70484.97

6. Adjusted Gross Income (sum of items 4 and 5). Enter total here: \$ 70484.97

How to  
figure  
the tax

(Unmarried or legally separated persons qualifying as "Head of Household," check here ☐. See instructions.)  
(Surviving widows and widowers who qualify for special tax computation, check here ☐. See instructions.)

IF YOUR INCOME WAS LESS THAN \$5,000—Use Tax Table under your status deduction. This table allows about 10 percent of your income for charitable contributions, interest, taxes, medical expenses, etc. If your deductions exceed 10 percent, it will usually be to your advantage to itemize them and compute your tax on page 3.

IF YOUR INCOME WAS \$5,000 OR MORE—Compute tax on page 3. Itemize or use standard deduction, whichever is to your advantage.

Tax  
due or  
refund

7. Enter your tax from the Tax Table, or from line 13, page 3: \$ 31692.44

8. Less: A. Dividends received credit (line 8 of Schedule D) \$ \_\_\_\_\_  
B. Retirement income credit (line 10 of Schedule K) \$ \_\_\_\_\_

9. Balance (item 7 less the sum of items 8A and 8B): \$ 31692.44

10. Enter your self-employment tax from line 35, separate Schedule C: \$ 216.00

11. Add amounts shown in items 9 and 10: \$ 31908.44

12. Credits for amounts paid on your 1954 income tax:  
A. Tax withheld (in item 2, Column D above). Attach Forms W-2: \$ \_\_\_\_\_  
B. Payments on 1954 Declaration of Estimated Tax. Indicate District Director's office where paid: Omaha, Nebraska \$ 35000.00

13. If your tax (item 11) is larger than payments (item 12), the balance must be paid in full with return. Enter such balance here: \$ 291.56

14. If your payments (item 12) are larger than your tax (item 11) Enter the overpayment here: \$ 35000.00

Enter amount of item 14 you want: Credited on 1955 estimated tax \$ 35000.00 Refunded \$ \_\_\_\_\_

Make check or money order payable to District Director, I. R. S., for amount, if any, shown in item 13.

Do you owe any other Federal tax? ☐ Yes ☒ No. If "Yes," to which District Director's office and what kind of tax.

Is your wife (or husband) making a separate return for 1954? ☐ Yes ☒ No. If "Yes," write her (or his) name.

Did you pay anyone for assistance in the preparation of your return? ☒ Yes ☐ No. If "Yes," name and address.

J. J. Davis, Chgo., Ill., Ind.

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

Mark E. Schlude  
(Signature of taxpayer)

3/31/55 Marzalie Schlude  
(Signature of taxpayer's wife)

To ensure split-income benefits, husband and wife must include all their income and, even though only one

EXHIBIT 13-A

EXHIBIT 13-A TO STIPULATION OF FACTS

2. Enter total of all other dividends: listing name of corporation and amount

Enter total hours—

**Schedule B.—INCOME FROM INTEREST**

Name of payer	Amount	Name of payer	Amount
	\$		\$
Enter total here			

Enter total here—

## Schedule C Summary.—PROFIT (OR LOSS) FROM BUSINESS, FARMING, AND PARTNERSHIP

1. Business profit (or loss) from separate Schedule(s) C, line(s) 24
  2. Farm profit (or loss) from separate schedule, Form 1040F .....
  3. Partnership, etc., profit (or loss) from Form 1065, Schedule K ..
- Partnership name and address .....

Partnership name and address.

4. Total of lines 1, 2, and 3.....
5. Less: Net operating loss deduction (Attach statement)
6. Net profit (or loss) (line 4 less line 5).....

**Schedule D.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY**

1. From sale or exchange of property other than capital assets (from separate Schedule D)
2. From sale or exchange of capital assets (from separate Schedule D)

**Schedule E.—INCOME FROM PENSIONS OR ANNUITIES (See Instructions)**

### Part I.—General Rule

- |   |          |   |          |
|---|----------|---|----------|
| 1. Investment in contract.....  | \$ _____ | 4. Amount received this year.....                       | \$ _____ |
| 2. Expected return.....   | \$ _____ | 5. Amount excludable (line 4 multiplied by line 3)..... | \$ _____ |
| 3. Percentage of income to be excluded<br>(line 1 divided by line 2)..... | % _____  | 6. Taxable portion (excess of line 4 over line 5)       |          |

**Part II.—Where your cost will be recovered within three years and your employer has contributed part of the cost**

- |   |    |                                     |
|---|----|-------------------------------------|
| 1. Cost of annuity (amounts paid in) . . .  | \$ | 4. Amount received this year . . .  |
| 2. Cost received tax-free in past years . . |    | 5. Taxable income (excess of line 4 |
| 3. Remainder of cost (line 1 less line 2) . | \$ | over line 3) . . .                  |

## Schedule F.—INCOME FROM RENTS AND ROYALTIES

1. Kind and location of property	2. Amount of rent or royalty	3. Depreciation (explain in Schedule M) or depletion	4. Repairs (attach itemized list)	5. Other expenses (attach itemized list)
	\$	\$	\$	\$
1. Totals	\$	\$	\$	\$

2. Net profit (or loss) (column 2 less sum of columns 3, 4, and 5)

### Schedule G.—INCOME FROM OTHER SOURCES INCLUDING ESTATES AND TRUSTS

1. Estate or trust (Name and address) .....
2. Other sources (state nature) ..... attached schedule

TOTAL INCOME (OR LOSS) FROM ABOVE SOURCES (Enter here and as Item 8, page 1)

## Schedule H.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULE F

[illegible]

### Sec. 1.—EXEMPTIONS FOR INDIVIDUALS WITH GROSS INCOME OF LESS THAN \$600, OTHER THAN WIFE AND CHILDREN

1. Name of individual. Also give address if different from yours	2. Relationship	3. Did individual have gross income of \$800 or more in 1954?	4. If answer to 3 is "No" enter amount spent for individual's support in 1954 by— You (and your wife if this is a joint return). If 100%, write "all" 3	Others, and by individual from own funds 3

Enter here and on item 1 D, page 1, the number of individuals claimed above

**NOTE**—If exemption is based on your being designated as the one to claim a dependent, the necessary multiple support agreement must be attached.

## Summary of Taxable Income.

[fol. 98]

## Mark and Marzalie Schlude.

Year 1954.

Partnership Income (Fiscal Period  
April 1, 1953 to March 31, 1954)

	Mark Schlude	Marzalie Schlude	Total
Per Partnership Return.....	\$34,546.57	\$34,546.56	\$69,093.13
Less Dividend Income received 4/1/53 to 1/1/54.....	240.87	240.87	481.74
	<u>\$34,305.70</u>	<u>\$34,305.69</u>	<u>\$68,611.39</u>
Less Dividends received 1/1/54 to 3/31/54 .....	46.25	46.25	92.50
	<u>\$34,259.45</u>	<u>\$34,259.44</u>	<u>\$68,518.89</u>
Net Loss—Override Oil Deal.....			(124.31)
Income (Loss) From Rental Properties—Chi- cago			
614-16 Woodland Park .....	\$ 808.97		
3332 Giles Avenue.....	408.34		
7501 South Shore Drive.....	(447.70)		
1305 Chicago Avenue.....	135.37		904.98
4702 Cass Company—Omaha, Nebraska.....			618.35
Ordinary Income .....			<u>\$69,917.91</u>

[fol. 145]

## Override Oil Deal.

## Mark and Marzalie Schlude.

Year 1954.

Oil Income .....	\$ 25.69
Less Cost amortization .....	150.00
Net Loss .....	<u>(\$124.31)</u>
10 Year Amortization Cost ..	\$1,500.00

614-16 Woodland Park

131

Mark and Marzabe Schlindo

[fol. 99]

Year 1954

Income

\$12,500.00

Expenses

Management	\$ 623.91
Light	1,021.72
Gas	420.98
Water	257.40
Interest	292.60
Insurance	120.53
Janitor	630.00
Plumbing & Heating	545.94
Carpenter	594.23
Roof, Gutter & Brick	363.80
Social Security	12.49
Real Estate Taxes	385.04
Electric Repairs	87.60
Equipment	18.00
Plastering & Decorating	854.74
Coal	904.31
Supplies	262.85
Exterminator	220.00
Ashes and Hauling	172.50
Legal Service	136.00
Sewer and Boiler	230.70
Depreciation	1,363.44

9,260.65

\$ 3,239.35

Taxpayers Share, 25%

\$ 808.97

Depreciation

Date acquired	Dec. 4, 1951
Estimated Life	20 Years
Remaining Life	17 Yr. 11 Mos.
Cost	\$27,261.00
Depreciation	\$ 1,363.44

Jul. 1961

Mark and Marjorie Schmidt

Year 1954

Income

Expenses

Real Estate Taxes \$ 67.04

Plastering &amp; Decorating 50.00

Depreciation 111.29

Profit

\$ 408.31

Depreciation

Date Acquired 1941

Estimated Life 15 yrs.

Remaining Life 3 yrs.

Cost \$207.57

Depreciation 1954 \$111.29

Depreciation accumulated to Dec

31, 1953 \$536.40



7801 South Shore Drive

133

Mark and Marzahn Schlude

[fol. 101]

Year 1954

Income ..... \$ 800.00

Expense

Management ..... \$ 35.00

Water ..... 2.60

Insurance ..... 45.75

Plumbing and Heating ..... 110.00

Real Estate Taxes ..... 691.72

\$ 886.07

Net Loss ..... (\$ 86.07)

Taxpayers Share 50% ..... (\$ 43.04)

Depreciation ..... 404.69

Net Loss ..... (\$ 447.70)

Taxpayers Depreciation

Date acquired

Dec. 31, 1949

Estimated Life

15 years

Cost

\$ 6,067.35

Depreciation 1954

\$ 404.69

[Vol. 102]

Mark and Marzalie Schlude

Year 1954

Income ..... \$ 780.00

Expense

Management ..... \$ 39.00

Insurance ..... 114.75

Roof, Gutter and Brick ..... 34.00

Real Estate Taxes ..... 138.14

Sewer and Boiler ..... 48.50

Depreciation ..... 134.88

590.27

Net Profit ..... \$ 270.73

Taxpayers Share 50% ..... \$ 135.37

Depreciation

Date acquired ..... Sept. 18, 1947

Estimated Life ..... 20 Years

Remaining Life ..... 14½ Years

Cost ..... \$ 2,250.33

Depreciation 1954 ..... \$ 134.88

Mark and Marzalie Schlude

Year 1954

{fol. 103}

Income Oct. 1, 1954 to Dec. 31, 1954 \$ 4,000.25

Expenses Oct. 1, 1954 to Dec. 31, 1954

Heat	\$ 204.20	
Electricity	77.49	
Gas and Water	60.70	
Custodian Expense	50.00	
Depreciation - Building	1,395.78	
Depreciation - Furniture		
Fixtures	355.08	
Real Estate Taxes	846.00	
Building Repairs	119.46	
Interest	800.21	
Mortgage Expenses	56.32	
Collection Expense	45.00	4,350.00

Net Profit \$ 618.25

## Depreciation - Building

## Sum of Digits Method

Date acquired	Oct. 1, 1954
Life	34 Yrs.
Cost	\$97,704.80
Depreciation 10-1-54 to 12-31-54	\$ 1,395.78
(34 595 / 97704.80 = 5583.14)	
31 of 5583.14	

## Depreciation - Furniture and Fixtures

## Straight line method

Date acquired			Oct. 1, 1954
			Depreciation
			10-1-54 to
	Cost	Life	12-31-54
Heating Plant	\$7,530.61	10 yrs.	\$188.26
Refrigerators	1,167.16	3 yrs.	97.26
Ranges	636.03	3 yrs.	53.00
Cupboards Miscellaneous	139.26	2 yrs.	17.41

\$355.93

Sale of Lot 297 in the Berwyn Subdivision  
Chicago.

[fol. 104]

Mark and Marzalie Schlude.

Year 1954.

## Green and Dato Lots

Date Acquired .....	1939
Date Sold .....	1954
Sales Price .....	\$509,000
Cost Price .....	\$158,722

Long term capital gain ..... \$341,28

Taxpayers Share of Gain 50% ..... \$170.64

[fol. 132]

## Additional Information.

On October 1, 1954 Mark and Marzalie Schlude of 309 South 19th Street, Omaha, Nebraska purchased all of the outstanding stock of the corporation from R. W. Dillon and immediately thereafter on October 1, 1954, dissolved the corporation. The stock was purchased by Mark and Marzalie Schlude in order to acquire the assets of the corporation. The total purchase price of the stock amounted to \$64,641.12 and the assets and liabilities of the company were taken into account October 1, 1954 in the books of account of Mark and Marzalie Schlude, as shown by the separate attached balance sheet. Mark and Marzalie Schlude paid \$64,641.12 for the net assets of the company whereas the net assets carried on the corporations books amounted only \$36,043.34, or an increase of \$28,597.78. A reconciliation of the total purchase price to the capital account is presented below:

Total Purchase Price .....	\$64,641.12
Less Borrowed Funds .....	15,536.52
	<u>\$49,104.60</u>

## Cash Advanced For:

Mortgage Escrow Deposit .....	\$811.05
Mortgage Expense .....	36.35
	<u>\$847.40</u>

Capital—Mark and Marzalie Schlude ..... \$49,952.00

1954

GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY

USE WITH INDIVIDUAL, FIDUCIARY, OR PARTNERSHIP RETURNS

1954

For Calendar Year 1954, or other taxable year beginning 1954, and ending 195

Name and Address

Check type of return filed  
☐ Form 1040 ☐ Form 1041 ☐ Form 1065

(I) PROPERTY OTHER THAN CAPITAL ASSETS

a. Kind of property (if necessary, attach statement of descriptive details not shown below)	b. Date acquired (mo., day, yr.)	c. Date sold (mo., day, yr.)	d. Gross sales price (contract price)	e. Depreciation allowed (or allowable) since acquisition or March 1, 1913 (attach schedule)	f. Cost or other basis and cost of subsequent improvements (if not purchased, attach explanation)	g. Expenses of sale	h. Gain or loss (column d plus column e less sum of columns f and g)
1.							
2. Net gain (or loss). Enter here and on line 1, Schedule D, Form 1040, or as item 8 (a), page 1, Form 1041, or as item 11, page 1, Form 1065.							

(II) CAPITAL ASSETS

Short-Term Capital Gains and Losses—Assets Held Not More Than 6 Months

2.							
4. Enter your share of net short-term gain (or loss) from partnerships and fiduciaries.							
5. Enter unused capital loss carryover from 5 preceding taxable years (Attach statement).							
6. Net short-term gain (or loss) from lines 3, 4, and 5. Enter here and in Schedule D, Form 1041, or as item 26, page 1, Form 1065.							

Long-Term Capital Gains and Losses—Assets Held More Than 6 Months

7.							
8. Enter the full amount of your share of net long-term gain (or loss) from partnerships and fiduciaries.							
9. Net long-term gain (or loss) from lines 7 and 8. Enter here and in Schedule D, Form 1041, or as item 27, page 1, Form 1065.							

• LINES 10 THROUGH 25 NOT APPLICABLE TO FIDUCIARIES AND PARTNERSHIPS

Gain or Loss To Be Taken Into Account	a. Gain	b. Loss
10. Enter net short-term gain (or loss) from line 6.	\$ 170.64	
11. Enter net long-term gain (or loss) from line 9.		
Use lines 12 through 15 only if gains exceed losses in lines 10 and 11.		
12. Enter short-term gain (line 10, col. a) reduced by any long-term loss (line 11, col. b).	\$ 170.64	
13. Enter long-term gain (line 11, col. a) reduced by any short-term loss (line 10, col. b).	\$ 85.32	
14. Enter 50 percent of line 13.	\$ 85.32	
15. Enter here and on line 2, Schedule D, Form 1040, the sum of lines 12 and 14.		
Use lines 16 and 17 only if losses exceed gains in lines 10 and 11.		
16. Enter the excess of losses over gains on lines 10 and 11.		
17. Enter here and on line 2, Schedule D, Form 1040, the smallest of the following: (a) the amount on line 16; (b) taxable income computed without regard to capital gains and losses and the deduction for exemptions; or (c) \$1,000.		

COMPUTATION OF ALTERNATIVE TAX FOR INDIVIDUALS (Form 1040)

(See instructions on other side as to when the alternative tax applies)

18. Enter from page 3, Form 1040, the income from line 5 if separate return or line 7 (a) if joint return.	\$ 34,142.49
19. Enter amount from line 14, column a, above, if separate return, or half of such amount if joint return.	\$ 42.66
20. Balance (line 18 less line 19).	\$ 34,099.83
21. Enter tax on amount on line 20 (Use applicable Tax Rate Schedule in Form 1040 Instructions).	\$ 1,5821.89
22. If joint return, multiply amount on line 21 by two.	\$ 31,649.78
23. Enter 50 percent of line 19.	\$ 21.33
24. If joint return, multiply amount on line 23 by two.	\$ 42.66
25. Alternative tax (line 21 plus line 23 if separate return; line 22 plus line 24 if joint return). If smaller than amount on line 6 or line 7(c), page 3, Form 1040, enter this alternative tax on line 8, page 3, Form 1040.	\$ 31,692.44

NOTE.—In lines 18 to 25 the treatment in the case of a joint return is also applicable to a return of a surviving widow or widower.

16-70800-1



**PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION**  
 (For Computation of Self-Employment Tax, see Page 3)  
**PARTNERSHIPS AND JOINT VENTURES SHOULD FILE ON FORM 1065**

**1954**

For Calendar Year 1954 or other taxable year beginning

1954, and ending

195

Owner's Name and Address (from Form 1040)

MARZALIE SCHLUDE - 459 BEVERLY DRIVE

OMAHA, NEBRASKA

Item (see instructions—page 2)

A. Principal business activity

BALLROOM DANCING

INSTRUCTION

(Detail trade, wholesale trade, lawyer, etc.)

(Principal product or service)

B. Business name

ARTHUR MURRAY DANCE STUDIO

C. Number of places of business

6

D. Did you pay social security taxes for any employees for any quarter of 1954? ☐ Yes ☐ No

E. Enter your employer identification number, if any 47 035 4832

F. Business address 309 So. 19th Street

Omaha

(Street and number or rural route)

(City, town, post office)

G. How many months in the year did you own this business? \_\_\_\_\_  
 Did you own this business on December 31, 1954? ☒ Yes ☐ No  
 Was this a seasonal business which was closed for more than two months during the year? ☐ Yes ☒ No

Douglas

Nebraska

(County)

(State)

Line (see instructions—page 2)

1. Total receipts \$ \_\_\_\_\_ less allowances, rebates, and returns \$ \_\_\_\_\_

2. Inventory at beginning of year

3. Merchandise purchased \$ \_\_\_\_\_ less any items withdrawn from business for personal use \$ \_\_\_\_\_

4. Cost of labor (do not include salary paid to yourself)

5. Material and supplies

6. Other costs (explain in Schedule C-2)

7. Cost of goods manufactured or purchased (total of lines 3, 4, 5, and 6)

8. Total of line 2 plus line 7

9. Enter inventory at end of year

10. Cost of goods sold (line 8 less line 9)

11. Gross profit (line 1 less line 10)

**OTHER BUSINESS DEDUCTIONS**

12. Salaries and wages not included in line 4 (except any paid to yourself)

13. Rent on business property

14. Interest on business indebtedness

15. Taxes on business and business property

16. Losses of business property (attach statement)

17. Bad debts arising from sales or services

18. Depreciation and obsolescence (explain in Schedule C-1)

19. Repairs (explain in Schedule C-2)

20. Depletion of mines, oil and gas wells, timber, etc. (attach schedule)

21. Amortization of emergency and grain storage facilities (attach statement)

22. Other business expenses (explain in Schedule C-2)

23. Total of lines 12 to 22

24. Enter net profit (or loss) (line 11 less line 23). Also enter on line 25, page 3 of this schedule, and on line 1,

Schedule C Summary, Form 1040

**Schedule C-1. EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED ON LINE 18**

Kind of property (if buildings, state material of which constructed). Exclude land and other nondepreciable property	2. Date acquired	3. Cost or other basis	4. Depreciation allowed (or allowable) in prior years	5. Method	6. Rate (%) or life (years)	7. Depreciation for 1954 year
		\$	\$			\$

**Schedule C-2. EXPLANATION OF LINES 8, 19, AND 23**

Line No.	Explanation	Amount	Line No.	Explanation	Amount
		\$			\$

If you have more than one business, a separate page must be completed for each business. This form should be completed and filed showing the aggregate net profit from each business.

**(See Instructions—Page 4)**  
**COMPUTATION OF SELF-EMPLOYMENT TAX**  
**(For old-age and survivors insurance)**

NAME OF SELF-EMPLOYED PERSON (a separate schedule must be filed for each self-employed person)

MARZALIN SCHLUDE

STATE BUSINESS ACTIVITIES, IF ANY, SUBJECT TO SELF-EMPLOYMENT TAX (for example: Restaurant, Building Contractor)

BALLROOM DANCING INSTRUCTION

Line (See Instructions—Page 4)				
25.	Net profit (or loss) shown on line 24, page 1 (Enter aggregate amount if more than one business)	\$		
26.	Losses of business property shown on line 16, page 1	\$		
27.	Total of lines 25 and 26	\$		
28.	Less: Net income (or loss) from excluded services or sources included in line 27. Specify excluded services or sources	\$		
29.	Net earnings from self-employment (line 27 less line 28)	\$		
30.	Net earnings (or loss) from self-employment from partnerships, joint ventures, etc. (from column 11, Schedule K, Form 1065)		34546	56
31.	Total net earnings (or loss) from self-employment (line 29 plus line 30) (If total of net earnings is under \$400, do not make any entries below)	\$	34546	56
32.	Maximum amount subject to self-employment tax	\$	3,600	00
33.	Less: Wages paid to you during the taxable year which were subject to withholding for old-age and survivors insurance. (If such wages exceed \$3,600, enter \$3,600)		None	
34.	Maximum amount subject to self-employment tax after adjustment for wages	\$	3600	00
35.	Self-employment income subject to tax—Line 31 or 34, whichever is smaller	\$	3600	00
36.	Self-employment tax—3 percent of amount on line 35. Enter here and as item 10, page 1, Form 1040	\$	108	00

**IMPORTANT—FILL IN ITEMS BELOW COMPLETELY BUT DO NOT DETACH**

# **PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION**

(For Computation of Self-Employment Tax, see Page 3)  
PARTNERSHIPS AND JOINT VENTURES SHOULD FILE ON FORM 1065

**1954**

For Calendar Year 1954 or other taxable year beginning

1954, and ending

195

Owner's Name and Address (from Form 1040)

MARK E. SCHLUDE

459 BEVERLY DRIVE

OMAHA, NEBRASKA

Item (see instructions—page 2)

A. Principal business activity

BALLROOM DANCING

INSTRUCTION

(Retail trade, wholesale trade, lawyer, etc.)

(Principal product or service)

B. Business name

ARTHUR MURRAY DANCE STUDIO

C. Number of places of business

6

D. Did you pay social security taxes for any employees for any quarter of 1954? ☒ Yes ☐ No

E. Enter your employer identification number, if any 470354832

F. Business address: 300 South 24th Street Omaha

(Street and number or rural route)

(City, town, post office)

Douglas Nebraska

(County)

(State)

Line (see instructions—page 2)

1. Total receipts \$ less allowances, rebates, and returns \$

2. Inventory at beginning of year \$

3. Merchandise purchased \$ less any items withdrawn from business for personal use \$

4. Cost of labor (do not include salary paid to yourself)

5. Material and supplies

6. Other costs (explain in Schedule C-2)

7. Cost of goods manufactured or purchased (total of lines 3, 4, 5, and 6)

8. Total of line 2 plus line 7 \$

9. Enter inventory at end of year

10. Cost of goods sold (line 8 less line 9)

11. Gross profit (line 1 less line 10) \$

## **OTHER BUSINESS DEDUCTIONS**

12. Salaries and wages not included in line 4 (except any paid to yourself) \$

13. Rent on business property

14. Interest on business indebtedness

15. Taxes on business and business property

16. Losses of business property (attach statement)

17. Bad debts arising from sales or services

18. Depreciation and obsolescence (explain in Schedule C-1)

19. Repairs (explain in Schedule C-2)

20. Depletion of mines, oil and gas wells, timber, etc. (attach schedule)

21. Amortization of emergency and grain storage facilities (attach statement)

22. Other business expenses (explain in Schedule C-2)

23. Total of lines 12 to 22

24. Enter net profit (or loss) (line 11 less line 23). Also enter on line 25, page 3 of this schedule, and on line 1,

Schedule C Summary, Form 1040

## **Schedule C-1. EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED ON LINE 18**

1. Kind of property (if buildings, state material of which constructed). Exclude land and other nondepreciable property	2. Date acquired	3. Cost or other basis	4. Depreciation allowed (or allowable) in prior years	5. Method	6. Rate (%) or life (years)	7. Depreciation for this year
		\$	\$			\$

## **Schedule C-2. EXPLANATION OF LINES 6, 19, AND 23**

Line No.	Explanation	Amount	Line No.	Explanation	Amount
		\$			\$

MARK E. SCHLUDE

STATE BUSINESS ACTIVITIES, IF ANY, CORRESPOND TO SELF-EMPLOYMENT TAX (for example: Restaurant, Building Contractor)

**BALLROOM DANCING INSTRUCTION**

Line (See instructions—Page 4)

25. Net profit (or loss) shown on line 24, page 1 (Enter aggregate amount if more than one business).....	\$		
26. Losses of business property shown on line 16, page 1.....	\$		
27. Total of lines 25 and 26.....	\$		
28. Less: Net income (or loss) from excluded services or sources included in line 27..... Specify excluded services or sources.....	\$		
29. Net earnings from self-employment (line 27 less line 28).....	\$		
30. Net earnings (or loss) from self-employment from partnerships, joint ventures, etc. (from column 11, Schedule K, Form 1065).....		34546	57
31. Total net earnings (or loss) from self-employment (line 29 plus line 30)..... (If total of net earnings is under \$400, do not make any entries below)	\$	34546	57
32. Maximum amount subject to self-employment tax.....	\$	3,600	00
33. Less: Wages paid to you during the taxable year which were subject to withholding for old-age and survivors insurance. (If such wages exceed \$3,600, enter \$3,600).....		None	
34. Maximum amount subject to self-employment tax after adjustment for wages.....	\$	3600	00
35. Self-employment income subject to tax—Line 31 or 34, whichever is smaller.....	\$	3600	00
36. Self-employment tax—3 percent of amount on line 35. Enter here and as item 10, page 1, Form 1040.....	\$	108	00

**IMPORTANT—FILL IN ITEMS BELOW COMPLETELY BUT DO NOT DETACH**



**ITEMIZED DEDUCTIONS—FOR PERSONS NOT USING TAX TABLE OR STANDARD DEDUCTION**  
 If Husband and Wife (Not Legally Separated) File Separate Returns and One Itemizes Deductions, the Other Must Also Itemize.

Describe deductions and state to whom paid. If more space is needed, attach additional sheets

<b>Contributions</b>			\$
	Total Contributions (not to exceed 20 percent of item 6, page 1, except where contributions to churches, schools, and hospitals are included). (See instructions)		\$
<b>Interest</b>			\$
	Total Interest		\$
<b>Taxes</b>			\$
	Total Taxes		\$
<b>Medical and dental expense</b> (If over 63, see instructions)	Do not enter any expense compensated by insurance or otherwise		
	A. Medicine and Drugs	B. Other	
	1. Net Expenses (Attach itemized list)	\$	\$
	2. Enter in Column A, 1 percent of item 6, page 1	\$	
	3. Enter in Column B, excess of Column A, line 1, over line 2		\$
	4. Total of Column B, lines 1 and 3		\$
5. Enter 3 percent of item 6, page 1		\$	
6. Allowable amount (excess of line 4 over line 5). (See instructions for limitations)			\$
<b>Child Care</b>	Expenses for care of children and certain other dependents (see instructions). Not to exceed \$600. (Attach statement)		
<b>Losses from fire, storm, or other casualty, or theft</b>			\$
	Total Allowable Losses (not compensated by insurance or otherwise)		\$
<b>Miscellaneous</b>			\$
	Total Miscellaneous Deductions		\$
<b>TOTAL DEDUCTIONS (Enter on line 2 of Tax Computation, below)</b>			\$

**TAX COMPUTATION**

1. Enter Adjusted Gross Income as shown in line 6, page 1	\$	70,84	97
2. If deductions are itemized above, enter total of such deductions. If deductions are not itemized and line 1, above, is \$5,000 or more: (a) married persons filing separately enter \$500; (b) all others enter 10 percent of line 1, but not more than \$1,000	\$	1,000	00
3. Subtract line 2 from line 1. Enter the difference here	\$	69,84	97
4. Multiply \$600 by total number of exemptions claimed in item 1E, page 1. Enter result here	\$	1,200	00
5. Subtract line 4 from line 3. Enter the difference here. This is your Taxable Income	\$	68,64	97
6. If you are a single person, a married person filing separately, or a head of household— Single persons and married persons filing separately use Tax Rate Schedule I in the instructions to figure tax on amount on line 5; heads of household use Tax Rate Schedule II.			
7. If this is a joint return, or if you qualify to file as a surviving widow or widower— (a) Enter one-half of amount on line 5			
(b) Use Tax Rate Schedule I in the instructions to figure tax on amount on line 7 (a)			
(c) Multiply amount on line 7 (b) by 2			
8. If alternative tax is applicable, enter the tax from separate Schedule D	\$	31,765	24
Disregard lines 9 through 12, and copy on line 13 the same figure you entered on line 6, 7 (c), or 8, unless you used itemized deductions.	\$	31,692	44
9. Enter here income tax payments to a foreign country or U.S. possession (Attach Form 1116)	\$		
10. Enter here any income tax paid at source on tax-free covenant bond interest	\$		
11. Enter here credit for partially tax-exempt interest (See instructions for limitation)	\$		
12. Add the figures on lines 9, 10, and 11. Enter the total here	\$		
13. Subtract line 12 from line 6, 7 (c), or 8, whichever is applicable. Enter difference here and as item 7, page 1.	\$	31,692	44



0-00000-0

A

3. Total.....	\$
3. Less: Exclusion of \$50. Apply exclusion first to Col. A and excess, if any, to Col. B.....	
4. Balance.....	\$
5. Enter in Column B, the amount from Column A, line 4.....	
6. Total dividends to be entered on line 1, Schedule A, page 2 (total of Column B, lines 4 and 5).....	

## 7. (a) 4% of amount on line 4, Column B, above

(b) Tax shown on line 6, 7 (c); or 8, page 3, less the amount, if any, on line 9, page 3; or, if Tax Table is used, the tax in item 7, page 1.

(c) 2% of taxable income—line 5, page 3; if alternative tax is applicable, line 20, Schedule D (twice line 20 in the case of a joint return).

(Taxable income, for those using the Tax Table to compute tax, is the amount shown in Item 6, page 1, less 10% thereof and less the deduction for exemptions (Item 1E, page 1, multiplied by \$600))

8. Enter here and as item 8A, page 1, the smallest of the amounts on lines 7 (a), 7 (b), or 7 (c), above

NOTE: If both husband and wife have qualifying dividends, an exclusion shall be allowed to each on line 3 to the extent of the dividends received but not to exceed \$50 each.

If separate return, use Column B only. If joint return, use one column for husband and one for wife.

Did you receive earned income in excess of \$600 in each of any 10 calendar years before the taxable year 1954? .....

If answer above is "Yes" in either column, furnish all information below in that column.

1. Retirement income for taxable year:

(a) For taxpayers under 65 years of age:

Enter only income received from pensions and annuities under public retirement systems. (Do not enter pensions, annuities, and retirement pay from Armed Forces.)

(b) For taxpayers 65 years of age and older:

Enter total of pensions and annuities, retirement pay from Armed Forces, interest, rents, and dividends included in gross income in this return.....

2. Enter here amount shown in line 1 or \$1,200, whichever is lesser.

2. Deduct

(a) Amounts received in taxable year as pensions or annuities under the Social Security Act, the Railroad Retirement Acts, and certain other exclusions from gross income. (See instructions)

(b) Compensation for personal services received in the taxable year 1954 in excess of \$900 (Line 3 (b) does not apply to persons 75 years of age or over.)

4. Total of lines 3 (a) and 3 (b)

E. Balance (line 2 minus line 4)

6. Tentative credit (20 percent of line 5)

7. Total tentative credit on this return (total of columns A and B, line 6)

6. Amount of tax shown on Item 7, page 1

Less: Credit for dividends from line 8, Schedule J, above

2. Balance of line 8.

18. Retirement income credit. Enter here and as item 8B, page 1, the amount on line 7 or line 9, whichever is smaller.

I declare under the penalties of perjury that I prepared this return for the person(s) named herein; and that this return (including any accompanying schedules and statements) is, to the best of my knowledge and belief, a true, correct, and complete return based on all the information relating to the matters required to be reported in this return of which I have any knowledge.

**Signature**

**Abstract**

19

**Schedule Reflecting Contract Amount of Deferred Income  
and Amount of Deferred Income Collected and  
Uncollected at End of Each Fiscal Year.**

**Arthur Murray Dance Studio—A Partnership.**

	March 31, 1950	March 31, 1951	March 31, 1952	March 31, 1953	March 31, 1954
<b>Contract Amount of Deferred Income</b>					
Ending Balance .....	\$ 72,611.87	\$106,541.70	\$131,143.92	\$235,942.23	\$248,740.30
Beginning Balance .....	37,844.04	72,611.87	106,541.70	131,143.92	235,942.33
<b>Increase .....</b>	<b>\$ 34,767.83</b>	<b>\$ 33,929.83</b>	<b>\$ 24,602.22</b>	<b>\$104,798.41</b>	<b>\$ 12,797.97</b>
<b>Students Accounts Receivable (Installment Contracts Carried by Studio, Notes Not Yet Processed Through the Bank, and Unpaid Balances on Planned Cash Courses)</b>					
Ending Balance .....	\$ 29,999.17	\$ 55,241.99	\$ 63,627.23	\$ 86,698.33	\$ 85,177.10
Beginning Balance .....	10,565.42	29,999.17	55,241.99	63,627.23	86,698.33
<b>Increase or Decrease .....</b>	<b>\$ 19,433.75</b>	<b>\$ 25,242.82</b>	<b>\$ 8,385.24</b>	<b>\$ 23,071.10</b>	<b>\$ (1,521.23)</b>
<b>Reserve Fund Held by Bank on Students Notes Financed</b>					
Ending Balance .....	\$ 13,835.78	\$ 8,112.28	\$ 7,943.74	\$ 37,747.61	\$ 34,533.22
Beginning Balance .....	13,404.09	13,835.78	8,112.28	7,943.74	37,747.61
<b>Increase or Decrease .....</b>	<b>\$ 431.69</b>	<b>\$ (5,723.50)</b>	<b>\$ (168.54)</b>	<b>\$ 29,803.87</b>	<b>\$ (3,214.39)</b>
<b>Deferred Income Collected—(Considering Reserve Fund Held by Bank as Collected)</b>					
Ending Balance .....	\$ 42,612.70	\$ 51,299.71	\$ 67,516.69	\$149,244.00	\$163,563.20
Beginning Balance .....	27,278.62	42,612.70	51,299.71	67,516.69	149,244.00
<b>Increase .....</b>	<b>\$ 15,334.08</b>	<b>\$ 8,687.01</b>	<b>\$ 16,216.98</b>	<b>\$ 81,727.31</b>	<b>\$ 14,319.20</b>
<b>Deferred Income Collected—(Considering Reserve Fund Held by Bank as Not Collected Until Funds Are Released and Made Available for Withdrawal by Bank)</b>					
Ending Balance .....	\$ 28,776.92	\$ 43,187.43	\$ 59,572.95	\$111,496.39	\$129,029.92
Beginning Balance .....	13,874.53	28,776.92	43,187.43	59,572.95	111,496.39
<b>Increase .....</b>	<b>\$ 14,902.39</b>	<b>\$ 14,410.51</b>	<b>\$ 16,385.52</b>	<b>\$ 51,923.44</b>	<b>\$ 17,533.59</b>

# ENROLLMENT AGREEMENT AND CONTRACT WITH STUDENT FOR INSTRUCTION

I agree to take a course of \_\_\_\_\_ of \_\_\_\_\_ Phone No. \_\_\_\_\_  
 \_\_\_\_\_ Hour Tuition Cash Discount Net Down Payment

I agree to pay \_\_\_\_\_ dollars at the time of signing this agreement and I agree to pay the balance as follows: \_\_\_\_\_

The Arthur Murray School of Dancing agrees that it will give the above mentioned \_\_\_\_\_ lessons within the period covered by this contract.

It is further agreed and understood that I shall not be relieved of my obligation to pay said tuition herein agreed upon, and that no deduction allowance or refunds for any tuition paid and due under this agreement shall be made by reason of my absence or withdrawal. I UNDERSTAND THAT NO REFUNDS WILL BE MADE UNDER THE TERMS OF THIS CONTRACT.

It is further agreed that all lessons shall be arranged for a definite time, and that in the event I wish to cancel any appointment, I agree to notify the Arthur Murray School of Dancing at least 24 hours in advance of my appointment in order to make arrangements for taking the lesson at a later date, proof of illness excepted. I understand that if I do not cancel my appointment 24 hours in advance as stated above, I shall be considered absent and the lesson will be forfeited.

I acknowledge that I have received a copy of this contract at the time of execution and I UNDERSTAND THAT THIS COURSE OF

\_\_\_\_\_ HOURS OF DANCING LESSONS EXPIRES ON \_\_\_\_\_

Signed this \_\_\_\_\_ day of \_\_\_\_\_ 19\_\_\_\_

ARTHUR MURRAY SCHOOL OF DANCING

Execution and delivery of copy

PUPIL \_\_\_\_\_

verified by \_\_\_\_\_

Registrar \_\_\_\_\_

EXHIBIT 15-0

NON CANCELLABLE CONTRACT

BASCO 1147-7

PRINTED U.S.A.

## EXTENSION AGREEMENT AND CONTRACT WITH STUDENT FOR INSTRUCTION

I, \_\_\_\_\_ of \_\_\_\_\_

hereby agree to extend my course of \_\_\_\_\_ hours to \_\_\_\_\_ hours and I further agree to pay total tuition for said lessons in the amount of \$ \_\_\_\_\_

I have paid \$ \_\_\_\_\_ on my original course.

I have paid \$ \_\_\_\_\_ today and agree to pay the balance as follows: \_\_\_\_\_

The Arthur Murray School of Dancing agrees that it will give the above mentioned \_\_\_\_\_ lessons within the period covered by this contract.

It is further agreed and understood that I shall not be relieved of my obligation to pay said tuition herein agreed upon, and that no deduction allowance or refunds for any tuition paid and due under this agreement shall be made by reason of my absence or withdrawal. I UNDERSTAND THAT NO REFUNDS WILL BE MADE UNDER THE TERMS OF THIS CONTRACT.

It is further agreed that all lessons shall be arranged for a definite time, and that in the event I wish to cancel any appointment, I agree to notify the Arthur Murray School of Dancing at least 24 hours in advance of my appointment in order to make arrangements for taking the lesson at a later date, proof of illness excepted. I understand that if I do not cancel my appointment 24 hours in advance as stated above, I shall be considered absent and the lesson will be forfeited.

I acknowledge that I have received a copy of this contract at the time of execution and I UNDERSTAND THAT THIS COURSE OF

\_\_\_\_\_ HOURS OF DANCING LESSONS EXPIRES ON \_\_\_\_\_

Signed this \_\_\_\_\_ day of \_\_\_\_\_ 19\_\_\_\_

ARTHUR MURRAY SCHOOL OF DANCING

Execution and delivery of copy

PUPIL \_\_\_\_\_

verified by \_\_\_\_\_

Registrar \_\_\_\_\_

EXHIBIT 16-P

NON CANCELLABLE CONTRACT

BASCO 1147-7-A

PRINTED U.S.A.

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EXHIBIT 16-P TO STIPULATION OF FACTS

[Vol. 108] EXHIBIT 16-0 TO STIPULATION OF FACTS

hereby enroll and agree to take a course of \_\_\_\_\_ private lessons, and I further agree to pay tuition for said lessons in the amount of \_\_\_\_\_ Dollars.

I agree to pay \_\_\_\_\_ Dollars at the time of signing this agreement, and I agree to pay the balance as follows \_\_\_\_\_

The Arthur Murray School of Dancing agrees that it will give the above mentioned lessons within the period covered by this contract.

It is further agreed and understood that I shall not be relieved of my obligation to pay said tuition herein agreed upon, and that no deduction allowance or refunds for any tuition paid and due under this agreement shall be made by reason of my absence or withdrawal. I UNDERSTAND THAT NO REFUNDS WILL BE MADE UNDER THE TERMS OF THIS CONTRACT.

It is further agreed that all lessons shall be arranged for a definite time and that in the event I wish to cancel any appointment I agree to notify the Arthur Murray School of Dancing at least 24 hours in advance of my appointment in order to make arrangements for taking the lesson at a later date, proof of illness excepted. I understand that if I do not cancel my appointment 24 hours in advance as stated above, I shall be considered absent and the lesson will be forfeited.

I acknowledge that I have received a copy of this contract at the time of execution and I UNDERSTAND THAT THIS

COURSE OF

HOURS OF DANCING LESSONS EXPIRES ON \_\_\_\_\_

Signed this \_\_\_\_\_ day of \_\_\_\_\_, 19\_\_\_\_

ARTHUR MURRAY SCHOOL OF DANCING

Pupil \_\_\_\_\_

Verified by \_\_\_\_\_

Registrar \_\_\_\_\_

EXHIBIT 17-Q

NON CANCELLABLE CONTRACT

### DEFERRED PAYMENT ENROLLMENT AGREEMENT AND CONTRACT WITH STUDENT FOR INSTRUCTION

I, \_\_\_\_\_ of \_\_\_\_\_ Phone No. \_\_\_\_\_

agree to take a course of \_\_\_\_\_

Hours	Tuition

I agree to pay \_\_\_\_\_ Dollars at the time of signing this agreement, and I agree to pay the balance of the down payment as follows \_\_\_\_\_

and the balance of \_\_\_\_\_ Dollars in the manner set forth in "negotiable note given for tuition" numbered \_\_\_\_\_ and executed at the time of signing this agreement.

The Arthur Murray School of Dancing agrees that it will give the above mentioned lessons within the period covered by this contract.

It is further agreed and understood that I shall not be relieved of my obligation to pay said tuition herein agreed upon, and that no deduction allowance or refunds for any tuition paid and due under this agreement shall be made by reason of my absence or withdrawal. I UNDERSTAND THAT NO REFUNDS WILL BE MADE UNDER THE TERMS OF THIS CONTRACT.

It is further agreed that all lessons shall be arranged for a definite time and that in the event I wish to cancel any appointment, I agree to notify the Arthur Murray School of Dancing at least 24 hours in advance of my appointment in order to make arrangements for taking the lesson at a later date, proof of illness excepted. I understand that if I do not cancel my appointment 24 hours in advance as stated above, I shall be considered absent and the lesson will be forfeited.

I acknowledge that I have received a copy of this contract and a copy of the "negotiable note given for tuition" at the time of their execution.

I FURTHER UNDERSTAND THAT THE LESSONS CALLED FOR UNDER THIS CONTRACT ARE TO BE TAKEN BY ME PERSONALLY AND THAT THIS CONTRACT OR THE LESSONS HEREIN CANNOT BE BY ME ASSIGNED. I UNDERSTAND THAT THIS COURSE OF \_\_\_\_\_ HOURS OF DANCING LESSONS

EXPIRES ON \_\_\_\_\_

Signed this \_\_\_\_\_ day of \_\_\_\_\_, 19\_\_\_\_

ARTHUR MURRAY SCHOOL OF DANCING  
Execution and delivery of copy

Pupil \_\_\_\_\_

Registrar \_\_\_\_\_

EXHIBIT 18-R

verified by \_\_\_\_\_

EXHIBIT 18-R TO STIPULATION OF FACTS

[FOL. 109] EXHIBIT 17-Q TO STIPULATION OF FACTS



DEFERRED PAYMENT EXTENSION AGREEMENT AND CONTRACT  
WITH STUDENT FOR INSTRUCTION

I, \_\_\_\_\_ of \_\_\_\_\_  
hereby agree to extend my contract of \_\_\_\_\_ hours to \_\_\_\_\_ hours and I further agree to  
pay total tuition for said lessons in the amount of \$ \_\_\_\_\_

I have paid \$ \_\_\_\_\_ on my original course.

I hereby agree to pay the balance of the down payment as follows,

\_\_\_\_\_ and the remainder of \$ \_\_\_\_\_ dollars in the manner

by a "negotiable note given for tuition" numbered \_\_\_\_\_ and executed at the time of

\_\_\_\_\_ and I agree that I will sign the above mentioned \_\_\_\_\_  
and covered by this contract.

I understand that I shall not be relieved of my obligation to pay said tuition herein agreed  
and no refund or refunds for any tuition paid and due under this agreement shall be made by  
\_\_\_\_\_ I UNDERSTAND THAT NO REFUNDS WILL BE MADE UNDER THE TERMS OF

\_\_\_\_\_ and that in the event I wish to cancel any  
\_\_\_\_\_ at least 48 hours in advance of my appointment in  
\_\_\_\_\_ at a later date, \_\_\_\_\_ of \_\_\_\_\_ accepted. I understand that if I do not  
\_\_\_\_\_ as stated above, I shall be considered absent and the lesson will be forfeited.

I have received a copy of this contract and a copy of the "negotiable note given for tuition"

\_\_\_\_\_ THAT THE LESSONS CALLED FOR UNDER THIS CONTRACT ARE TO BE TAKEN BY  
\_\_\_\_\_ THIS CONTRACT OR THE LESSONS CALLED FOR HEREIN CANNOT BE BY ME  
\_\_\_\_\_ OF DANCING LESSONS

\_\_\_\_\_ day of \_\_\_\_\_

\_\_\_\_\_ SCHOOL OF DANCING

Pupil \_\_\_\_\_

Registrar \_\_\_\_\_

NON ASSIGNABLE - NON-CANCELLABLE CONTRACT

EXHIBIT 19-S

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[Vol. 100] EXHIBIT 19-S



DEFERRED PAYMENT RENEWAL AGREEMENT AND CONTRACT  
WITH STUDENT FOR INSTRUCTION

I, \_\_\_\_\_ of \_\_\_\_\_  
hereby enroll and agree to take a course of \_\_\_\_\_ lessons, and I further agree to pay tuition for  
said lessons in the amount of \_\_\_\_\_ Dollars.

I agree to pay \_\_\_\_\_ dollars at the time of signing this agreement and I agree to pay  
the balance of the down payment for \_\_\_\_\_

and the balance of \_\_\_\_\_ dollars in the manner set forth in "negotiable note given for  
tuition" numbered \_\_\_\_\_ and executed at the time of signing this agreement.

The Arthur Murray School of Dancing agrees that it will give the above mentioned \_\_\_\_\_  
lessons within the period covered by this contract.

It is further agreed and understood that I shall be released of my obligation to pay said tuition herein agreed  
upon, and that no deduction allowance or refunds for any tuition paid and due under this agreement shall be made by  
reason of my absence or withdrawal. I UNDERSTAND THAT NO REFUNDS WILL BE MADE UNDER THE TERMS OF  
THIS CONTRACT.

It is further agreed that all lessons shall be arranged for a definite time, and that in the event I wish to cancel any  
appointment, I agree to notify the Arthur Murray School of Dancing at least 24 hours in advance of my appointment in  
order to make arrangements for taking the lesson at a later date, unless excepted. I understand that if I do not  
cancel my appointment 24 hours in advance as stated above, I shall be considered absent and the lesson will be forfeited.

I acknowledge that I have received a copy of this contract and a copy of the "negotiable note given for tuition"  
at the time of their execution.

I FURTHER UNDERSTAND THAT THE LESSONS CALLED FOR UNDER THIS CONTRACT ARE TO BE TAKEN BY  
ME PERSONALLY AND THAT THIS CONTRACT OR THE LESSONS CALLED THEREIN CANNOT BE BY ME  
ASSIGNED. I UNDERSTAND THAT THIS COURSE OF \_\_\_\_\_ HOURS OF DANCING LESSONS

EXPIRES ON \_\_\_\_\_

Signed this \_\_\_\_\_ day of \_\_\_\_\_ 19\_\_\_\_

ARTHUR MURRAY SCHOOL OF DANCING

Execution and delivery of copy \_\_\_\_\_

Pupil \_\_\_\_\_

verified by \_\_\_\_\_

Registrar \_\_\_\_\_

NON-ASSIGNABLE - NON-CANCELLABLE CONTRACT

EXHIBIT 20-7

ACME NO. 4

ORIGINAL

# ARTHUR MURRAY STUDIO

[Vol. 412] EXHIBIT 21-U TO STIPULATION OF FACTS

724 Pierce  
Sioux City, Ia  
83597

309 So. 19th Street  
Omaha, Nebr  
Jackson 2270

1238 M Street  
Lincoln, Nebr  
2 5800

388 D-W 18th Street  
Sioux Falls, South Dakota  
47795

No. of Mrs.  
Aunt Sale  
Known Payment  
Rel to finance  
Married  
or Single  
How long  
Phone No.  
State  
How long  
Phone No.  
How long

ALL QUESTIONS MUST BE ANSWERED  
If words "No" or "None" apply, please so indicate

Name \_\_\_\_\_ Nationality \_\_\_\_\_ Age \_\_\_\_\_ Height \_\_\_\_\_ Weight \_\_\_\_\_  
Home address, Street \_\_\_\_\_  
If Rural address give the following information  
Number \_\_\_\_\_ miles Direction \_\_\_\_\_ and Number \_\_\_\_\_ miles Direction \_\_\_\_\_ City \_\_\_\_\_  
Former address \_\_\_\_\_  
Business address \_\_\_\_\_  
(No. Street or Building) \_\_\_\_\_  
Name of employer \_\_\_\_\_ Occupation \_\_\_\_\_ (If self, what business)  
Salary \_\_\_\_\_ (Other income) \_\_\_\_\_ Banks with \_\_\_\_\_  
Real estate owned \_\_\_\_\_ Encumbered for \_\_\_\_\_  
Father or Mother \_\_\_\_\_ Address \_\_\_\_\_  
Wife's Father or Mother \_\_\_\_\_ Address \_\_\_\_\_  
References \_\_\_\_\_ Address \_\_\_\_\_  
Date \_\_\_\_\_ 194 \_\_\_\_\_ Applicant's signature \_\_\_\_\_

ALL QUESTIONS MUST BE ANSWERED  
Please TYPEWRITE all papers and have them signed in INA

No. \_\_\_\_\_

Omaha, Nebraska, \_\_\_\_\_ 19 \_\_\_\_\_

For value received, we jointly and severally promise to pay to the order of \_\_\_\_\_  
(Dealer's Name)

as follows: \_\_\_\_\_ DOLLARS  
(Total Amount of Note in Words)

Payable in \_\_\_\_\_ equal installments of \$ \_\_\_\_\_ each and \_\_\_\_\_ installments  
(No. of Even Payments) (No. of Uneven Payments, if Any)

each. Payments due on \_\_\_\_\_ day of every \_\_\_\_\_ month, beginning \_\_\_\_\_ 19 \_\_\_\_\_  
(Month)

until the principal sum with interest at the highest legal rate after maturity is paid at the office of the First National Bank of Omaha, Nebraska.

If any installment of this note is not paid at the place specified, the entire amount unpaid shall be due and payable forthwith to the election of the holder of the note. The failure to make prompt payment of any installment or installments shall not be considered a waiver of the terms of the foregoing clause or the establishment of a custom to the contrary.

In the event of suit on this note, the maker agrees that a reasonable attorney's fee shall be added as part of the costs of suit.

If the purchaser is a married woman, she agrees that the execution of this note is in reference to her individual estate and upon the faith and credit thereof and with the intention to charge for the payment of the obligation, her separate property, whether now owned or hereafter acquired.

The undersigned acknowledge receipt of a copy of this note on the date hereof

NEGOTIABLE INSTRUMENT.

Salesman Sign as  
Witness

Witness

EXHIBIT 21-U

Vol. 113]

## IN THE TAX COURT OF THE UNITED STATES

## SUPPLEMENTAL STIPULATION OF FACTS IN DOCKET

Nos. 62109, 69591, 69592, AND 69593 Filed April 8, 1958

At the trial of the above-captioned case, the parties, through their respective counsel, agreed to stipulate the amount of tuition paid other Arthur Murray Dance Studios for giving lessons contracted to be given by the Arthur Murray Dance Studios operated by the petitioners.

It is hereby stipulated that the tuition paid to other studios during the taxable years ending March 31, 1950 to March 31, 1954, inclusive, is as follows:

Taxable year ended March 31, 1950	\$ 592.00
Taxable year ended March 31, 1951	751.10
Taxable year ended March 31, 1952	825.00
Taxable year ended March 31, 1953	1,328.13
Taxable year ended March 31, 1954	4,955.32

Robert Ash, Attorney for Petitioners.

Arch. M. Cairnall, Chief Counsel, Internal Revenue Service.

## IN THE TAX COURT OF THE UNITED STATES

Docket No. 62109,

Docket No. 69591,

Docket No. 69592,

Docket No. 69593.

MARK E. SCHLUDÉ and MARZALIE SCHLUDÉ, MARK E. SCHLUDÉ, MARZALIE SCHLUDÉ, MARK E. SCHLUDÉ and MARZALIE SCHLUDÉ, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent,

North Courtroom,

U. S. Post Office Building,

Omaha, Nebraska.

March 24, 1958,

Monday, 10:50 a. m.

Met Pursuant to Notice.

Before: Honorable Eugene Black, Judge.

Appearances: Carl F. Bauersfeld, Attorney at Law, 712 Eye Street, Northwest, Washington 6, D. C., and Eino Viren, Attorney at Law, 904 City National Bank Building, Omaha, Nebraska, appearing on behalf of Mark E. Schludé and Marzalie Schludé, petitioners.

William E. McCormick, Special Attorney, Omaha Region Internal Revenue Service, Omaha, Nebraska (Honorable John Potts Barnes, Chief Counsel, Internal Revenue Service), appearing on behalf of Commissioner of Internal Revenue, respondent.

## Transcript of Proceedings

[fol. 115]. The Clerk: Docket No. 62109, Mark E. Schludé and Marzalie Schludé; Docket No. 69591, Mark E. Schludé

Docket No. 69592, Marzalie Schlude; and Docket No. 69593, Mark E. Schlude and Marzalie Schlude. Will counsel state their appearances. For the petitioners?

Mr. Bauersfeld: Carl F. Bauersfeld and Elmer Viren for petitioners.

The Clerk: For the respondent?

Mr. McCormick: William E. McCormick for the respondent.

The Court: Now, petitioners' counsel, are you ready at this time?

Mr. Bauersfeld: We are ready.

#### MOTION TO CONSOLIDATE GRANTED

The Court: Have these cases been consolidated?

Mr. Bauersfeld: There is a motion pending before the Court at this time.

The Court: To consolidate them?

Mr. Bauersfeld: Yes, Your Honor, a written motion.

The Court: The motion to consolidate is granted and petitioners' counsel may make his opening statement at this time.

#### OPENING STATEMENT ON BEHALF OF THE PETITIONERS

By Mr. Bauersfeld:

Mr. Bauersfeld: May it please the Court. These cases have been consolidated for trial and involve deficiencies in income tax as follows; In Docket No. 62109, the petitioners are Mark E. Schlude and Marzalie Schlude, involving the year 1950, and the amount of the deficiency is \$15,819.14; in Docket No. 69591, the petitioner is Mark E. Schlude, the year involved is 1952, and the amount of the deficiency is \$9,264.69; in Docket No. 69592, the petitioner is Marzalie Schlude, the year involved is 1952, and the amount of the deficiency is \$8,971.55; in Docket No. 69593, the petitioners are Mark E. Schlude and Marzalie Schlude, fol. 116 the years involved are 1953 and 1954, and the amount of the deficiency is \$83,395.82 for the year 1953 and \$11,544.32 for the year 1954.

The case presents two issues. There are a number of other issues in adjustments in the notices of deficiency.



They are all minor and petitioners have not made an assignment of error regarding those and is not pressing them.

The two issues pressed here are these:

Petitioners Mark E. Schlude and Marzalie Schlude as partners operate the local Arthur Murray Dance Studios in Nebraska and Omaha and surrounding territory. Its partnership keeps its books on the accrual method of accounting. It enters into contracts with students and treats prepaid tuition fees as deferred income. It reports as income each year that portion of the fees which represents lessons taught or cancelled during the year. In other words, the partnership reports the income it received from the dancing business when it was earned. The respondent determined the partnership must report as income the amount agreed to be paid by the student in the contract for dancing instruction. In other words, it is respondent's position that the mere execution of a contract for dancing instruction results in the recognition of the entire amount as income at the time the contract is executed. The question for decision is: Have the taxpayers reported their "true" income.

For the year 1950, there is one other issue which involves the statute of limitations. The determination of a deficiency for the year 1950 was made more than three years from date of filing petitioners' return for 1950 but less than five years. The question presented is: Does the statute of limitations bar the alleged deficiency for 1950?

The facts in a little more detail are these. On June 18, 1946, Mark E. and Marzalie Schlude formed a partnership for the purpose of conducting Arthur Murray Dance Studios in territories authorized by various franchise agreements received from Arthur Murray, Inc., New York, New York. The first studio was opened in Omaha, Nebraska, and subsequently during the years here involved, dance studios were opened in Lincoln, Nebraska; Sioux City, Iowa; Sioux Falls, South Dakota; and Grand Island, Nebraska.

[fol. 117] From the inception of the business, the partnership has maintained its books of account on a fiscal year ending March 31, and has used the accrual method of ac-

counting. The partners report their income on a calendar-year basis.

The partnership, Arthur Murray Dance Studios, contracts with students to give them a course of dance instruction. Some of the contracts extend beyond the end of the taxable year in which the contract was made. Students paid the partnership either in cash or by cash and deferred payment. When the deferred payment plan was used, the partnership received a note from the student which it transferred to a bank with full recourse. The bank would pay the partnership approximately 50 per cent of the face of the note and hold the balance until the student liquidated the note in its entirety.

The dance courses sold are primarily for private instruction of a specific number of hours or lessons. The partnership maintains a complete double-entry set of books and records including an individual record card for each student.

At the end of each fiscal year, an audit is conducted by a Certified Public Accountant and a complete analysis of each course sold is prepared. This analysis reflects among other things the gain or loss resulting from the cancellations, the amount of untaught hours and applicable deferred income at the end of the year. The earned income account is adjusted to the audit report as is the deferred income at the end of the year and the cancellations during the year. Each course having a beginning balance or sold during the year is completely accounted for and audited.

At various times during the year, the partnership is required to decrease the amount of some of the courses sold and re-write the contracts for smaller amounts. On other occasions it becomes necessary for the partnership to cancel the contract because of lack of student activity. If refunds of cash received are made, they are charged to deferred income and the unpaid balance of the contract is charged against the deferred income. Gain on cancellation of contracts is taken into account each year represented by the difference between payments received by the [fol. 118] partnership and income earned to the date of cancellation.

To give a course of instruction, it cost the partnership during the years here involved between approximately \$7.00 and \$8.50 per hour. The advance payments received for a course of dance instruction must be used to defray the operating costs and expenses applicable to the giving of instruction for which the payment was received. The amount of profit involved in an advance payment for dance instruction is undeterminable until subsequent events indicate the amount of the operating cost and expenses applicable thereto.

In the case at bar, the Commissioner has treated as income the yearly increases in deferred income on the books of the partnership. The effect of the Commissioner's action is to require the partnership to report as income the amount set forth in the contract with the student at the date it is executed.

It is the taxpayers' position that this case does not fall within the "claim of right" doctrine because that doctrine is applicable to cases dealing with the question of whether an item is or is not income. The question here involved is not whether the item is income but when the income shall be taken into account. In addition, the petitioners say that the "claim of right" doctrine can have no application in the instant case because it applies only when the actual cash money is received. Here the partnership did not receive all cash—although some cash was received. The "claim of right" doctrine has never been stretched to apply to a situation where the taxpayer did not actually receive cash money, as in this instance. It is further taxpayers' position that the partnership has reported its true income and that the method of accounting employed consistently and properly reflects its true income and is the only practical business way of keeping its books and reporting its income. The accounting method employed reflects the consistent application of generally accepted accounting principles and that the petitioners have reported their "true" income.

The Court: All right, Mr. McCormick, you may make your statement.

[vol. 119]

## OPENING STATEMENT ON BEHALF OF THE RESPONDENT

By Mr. McCormick:

Mr. McCormick: Summarizing the deficiencies, the respondent has determined the deficiencies were in income tax for the years 1950, 1952 and 1953 and 1954, in the total amount of \$128,995.52. Petitioners are equal partners in the Arthur Murray Dance Studio which has its principal place of business here in Omaha and the deficiencies here resulted mainly from the respondent increasing partnership income and consequently the amount of the partners' distributive shares.

The partnership contracted with students to give dancing lessons, the lessons to be paid for by three methods: (1) cash payments to the studio; (2) deferred payments to the studio; and (3) the giving of a negotiable note to the studio.

The studio discounted the notes with a bank, the bank giving the partnership 50 percent of the discounted proceeds and holding the other 50 percent in a reserve account until the notes were fully paid. The cash payments received directly from the students, the amount received at the time notes were negotiated to the bank, and the amounts in the reserve fund after notes were fully paid were either deposited or credited to the partnership general bank account without restriction as to use.

During the years involved here the partnership, which used the accrual method of accounting, deferred from inclusion in income on its books and returns amount of the contract prices allegedly representing uninstructioned hours of dancing lessons.

The respondent acting under the authority of Section 41 of the Internal Revenue Code of 1939 determined that the method of accounting employed by the partnership did not correctly reflect income and accordingly increased partnership income by the amount of the increases in the deferred income account from year to year. The petitioners dispute the correctness of this change and thus the primary issue is whether partnership income and consequently distributive shares should be increased by the amount of the increases

in the year and the balances shown in the partnership deferred income account. As already pointed out, this deferred income included prepaid receipts and accounts and notes receivable.

[fol. 120] Since the evidence will show that the prepaid receipts were without restriction as to use (except for the bank reserve fund) respondent contends that such amounts should be reported as income in the year of receipt. Respondent further contends that the amounts of deferred income representing accounts and notes receivable are properly income to an accrual-basis taxpayer for the period in which they arise.

One other issue for the year 1950 relates to whether the statute of limitations for assessment expired prior to the mailing of the notice of deficiency. Since the evidence will show that petitioners omitted from their gross income for the taxable year an amount properly includable there in excess of 25 percent of the gross income stated in the return filed, respondent contends that under Section 275 (c) of the Internal Revenue Code of 1939 the determination of a deficiency is not barred.

At this time I'd like to offer for filing with the Court a stipulation of facts with attached exhibits.

The Court: All right, the stipulation of facts, together with exhibits attached thereto, is received in evidence.

Mr. McCormick: The exhibits, Your Honor, are Nos. 1-A through 21-A.

The Court: All right, Mr. Bauersfeld, you may present your oral testimony.

Mr. Bauersfeld: Thank you, Your Honor. I will call Mr. Davis.

Whereupon,

ROBERT J. DAVIS, called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

Direct examination:

The Clerk: Would you be seated and state your name and address, please.



The Witness: Robert J. Davis, 1411 City National Bank Building, Omaha, Nebraska.

The Clerk: Thank you.

[fol. 121.] By Mr. Bauersfeld:

Q. What is your profession, Mr. Davis?

A. Public accounting.

Q. And how long have you been engaged in public accounting?

A. About 13 years.

Q. Are you a Certified Public Accountant?

A. Yes, sir, since 1948.

Q. And where is your business located?

A. Omaha, Nebraska, and surrounding territory.

Q. Have you ever taught accounting?

A. Yes, sir, at Boyles Business College for about three years.

Q. Do you belong to any professional societies?

A. Yes, sir, Nebraska Association of Certified Public Accountants.

Q. Do you know the petitioners, Mark E. Schlude and Marzalie Schlude?

A. Yes, sir.

Q. How long have you known them?

A. Since about 1946.

Q. How did you come to meet them?

A. When I was associated with Irwin-Imig Company, Certified Public Accountants, I was delegated to design and install the books of account for Mr. and Mrs. Schlude.

Q. What was the name of the company?

A. Irwin-Imig Company.

Q. Would you spell that?

A. I-r-w-i-n - I-m-i-g.

Q. What business were Mr. and Mrs. Schlude in?

Q. They had just received their franchise from Arthur Murray of New York to operate an Arthur Murray Dance Studio; at that time they came to have their records properly designed and installed.

Q. Will you describe the nature of the business?

A. The nature of the business is the operation of sell-

ing and teaching dance lessons in accordance with methods prescribed by Arthur Murray.

Q. I hand you exhibits Nos. 15 Q to 20-T of the stipulation of facts, which are contracts that are entered into by the Arthur Murray Dance Studios with students and ask you to explain when each of these contracts is used.

A. There are basically two types of contracts entered into between the partnership and students, the cash sale of selling dance courses and the deferred-payment plan of selling of dance courses. The exhibit marked No. 15 Q (fol. 122) refers to a cash course on an original course of dance instruction. The exhibit marked No. 16 P refers to a course on the extended plan of selling dance lessons. Exhibit No. 17 Q refers to a renewal course sold on the cash plan. Exhibit No. 18 R refers to a deferred payment renewal agreement on the original sale of dance lessons and exhibit No. 19 S refers to a deferred payment extension course and exhibit No. 20 T refers to a deferred payment renewal course.

Q. What is the difference between an original course, an extension course, and a renewal course?

A. An original course, as the name implies, is the first course of dance instructions sold to a student. The extension course is an extension privilege that is given to a student providing an extension of his course prior to the fifth hour of instruction on the original course. If the student extends his course prior to the fifth hour on the original course, he gets the privilege of enlarging his course on a lesser rate. The renewal course is the repeat sale to a student originally enrolled under the original agreement.

Q. I hand you exhibit No. 21 U, which is attached to the stipulation of facts, and ask you what the partnership does with notes of this type when received from students?

A. These notes are transferred to the bank after having been properly filled out.

Q. And at that time, what occurs?

A. After the bank deducts its interest charge from the face amount of the note, 50 percent of that balance is transmitted to the Studio and 50 percent is held back in reserve by the bank and not made available for withdrawal.

by the Studio. The note is transferred with recourse to the bank. At the time these notes were first put into effect with the bank the Studio actually entered into an arrangement with the bank where the Cashier's Check would be made out for the entire amount of the note made payable to the Studio and student and the student had to endorse that check before the Studio could deposit that to the Bank account. The whole purpose of that was that rather than a sale, this transaction took the form of a sale but actually it was a collection procedure. The whole purpose of transferring these notes to the bank (fol. 123) was that psychologically they believed the student would be more likely to pay the bank than the Studio. The bank makes no credit investigation insofar as the student's ability to repay. The notes are transferred to the bank with complete recourse against the Studio.

Mr. Bauersfeld: At this time, if the Court please, I'd like to offer in evidence as petitioners' exhibit No. 22-A, a photostatic copy of the franchise agreement dated June 18, 1946, between Arthur Murray, Inc., and Mark F. Schlude and Marzalie Schlude. I understand there is no objection.

Mr. McCormick: No objection.

The Court: Well, if it's not a joint exhibit, it will be Petitioner's Exhibit No. 22. It will be received.

Mr. Bauersfeld: Yes.

(The agreement referred to was marked and received in evidence as Petitioner's Exhibit No. 22.)

PETITIONER'S EXHIBIT 22

Agreement made in New York, N. Y., as of the 18 day of June, 1946, between Arthur Murray, Inc., of 11 East 43rd Street, New York City, hereinafter referred to as "Licensor", and Mark F. Stevens and Marzalie Stevens, hereinafter referred to as "Licensee"

Witnesseth:

Whereas, Licensor and its predecessors have for many years been engaged in conducting and supervising dancing schools and have developed unique and successful ways

of teaching dancing and conducting such schools and to supervise nationally known dancing schools of the highest reputation and excellence, with studios in the City of New York and elsewhere known as "Arthur Murray's," "Arthur Murray's Studio," "Arthur Murray School of Dancing" and or otherwise, and

Whereas, the Licensee is desirous of personally conducting a dancing school in the City of Omaha, State of Nebraska, and it is desirous of using the "Arthur Murray Method" and the name "Arthur Murray" in connection therewith;

[fol. 124] Now, Therefore, in consideration of the premises and for other good and valuable considerations, the receipt of which is hereby mutually acknowledged, and in further consideration of the mutual promises of the parties hereto, it is agreed as follows:

1. The Licensor hereby grants a license to the Licensee to use the "Arthur Murray Method" and name in connection with a dancing school or schools to be conducted by Licensee, in the City of Omaha, at such place or places within said City as shall be approved by Licensor in writing. The term school, studio or dancing school, as herein used, includes any branch or branches thereof, or any studio or studios operated or managed by Licensee. The Licensee shall reside in said City or its suburbs and agrees to devote his full time, and attention, and best efforts exclusively to the conduct of the said dancing school or schools under the name "Arthur Murray Dance Studio of Omaha," and agrees to register or file statements of his use of such name in the proper office of any County in which such dancing school, or studio, or any branch thereof may be located, and in any other Governmental office where it is mandatory or permissive that such a statement be filed, and agrees within twenty (20) days after the execution of this agreement, or within twenty (20) days after the filing of such a statement is permitted by the laws of the State, Territory and Municipality in which this license is effective to furnish Licensor with proof, satisfactory to Licensor, that such statements have been duly filed.

2. The Licensee agrees to pay the Licensor as long as Licensee conducts a dancing school as aforesaid under said name, or any similar name in weekly payments on Friday of each week, ten (10%) per centum of the gross receipts of such dancing school, or schools, so maintained by the Licensee for the preceding calendar week for which Licensor agrees to advise Licensee with respect to the establishment and necessary for the proper conduct of said dancing school and will furnish the Licensee with its latest and most available data and information concerning the methods of teaching dancing in accordance with the Arthur Murray Method; and Licensee agrees to conduct the said schools in accordance therewith.

(ol. 125) - Licensor will furnish Licensee with copies of promotion material and publicity originated and used by the Licensor in connection with the schools operated by the Licensor together with cuts of art work and circulars and other material originated and used by the Licensor, which said material will be furnished to Licensee at cost. Such cost is to be remitted by Licensee to Licensor on demand.

3. The parties hereto agree that it is of the utmost importance to the success of the Arthur Murray System and to all persons operating dancing schools under franchise from the Licensor, and to pupils enrolled at all Arthur Murray Dancing Studios or Schools that steps, methods of instruction and tuition rates be uniform at all Arthur Murray studios. Licensee agrees to establish and maintain the minimum hourly tuition rates established and promulgated by the Licensor; and to conduct the studio, or studios, to be maintained and managed by Licensee in accordance with the general policies of the Licensor as established from time to time, and to see to it that the methods of teaching and the steps taught are in accordance with the latest methods and steps promulgated by Licensor from time to time. Licensor will at such times, and as often as Licensor finds it necessary, inform Licensee of such policies, steps, methods and rates. Failure of the Licensee after being informed of such policies, methods or rates to maintain such policies, methods or rates shall be sufficient cause for cancellation of this license by the Licensor.



4. The Licensee agrees to honor the unused portion of paid courses of lessons of dancing pupils enrolled in any other Arthur Murray Dancing School owned or licensed by the Licensor, by giving dancing instructions to said pupils, and the Licensee shall be entitled to receive therefor the sum of \$1.50 per hour for each hour of dancing instruction so given by the Licensee on account of said unused lessons; and this payment shall be made by the Arthur Murray Dancing School which originally enrolled said dancing pupil or, at the option of the Licensor, by the Licensee, however, need not honor the unused portion of paid courses where the school which enrolled said pupil is then thirty (30) days or more in arrears in making payments for lessons given on its behalf.

[fol. 126] 5. The Licensor agrees that Licensor will likewise honor, or use Licensor's best efforts to cause to be honored, in any other Arthur Murray Dancing School unused courses of lessons of any dancing pupil, who may subscribe and pay for same in the Licensee's said dance school, and Licensee agrees to pay the sum of \$1.50 per hour for each hour of dance instruction given by the Licensor or such other Arthur Murray Dancing School, promptly upon being apprised of the amount due.

6. In order to protect and indemnify the Licensor from any and all claims (of whatsoever nature) which may be made or arise against Licensor as a result of the granting of this license to Licensee, and/or the expense of litigation, and to provide a fund out of which refunds may be made for unused lessons, payment for which has theretofore been made to the Licensee by Licensee's pupils, or, to reimburse Licensor or Licensor's other Licensee for redeeming same, the Licensee shall on Friday of each week, transmit to Licensor five per centum (5%) of Licensee's gross receipts for the preceding calendar week (in addition to the other payments herein specified to be made by Licensee) to be held by Licensor in escrow, as hereinafter set forth. Said fund may be held by Licensor on deposit in any bank in the City of New York selected by Licensor but separate and apart from other monies of Licensor or may be invested by Licensor in any type of bond, note or other certificate

of indebtedness issued by the United States Government, Licensee shall be credited periodically with such proportionate part of the income of such investments as Licensor shall determine should be properly allocated to Licensee. Licensor shall not be liable for any error of judgment or discretion or for anything other than bad faith or fraud in the handling of said fund or funds. ~~Such payments shall continue for the six (6) operating years next following the date hereof. Thereafter no further payments need be made to Licensee's Thrift Fund unless said fund is depleted by payments therefrom, in which case payments shall be continued or resumed by Licensee until said Fund amounts to the aforesaid percentage of Licensee's gross receipts for the six (6) operating years next following the date of this agreement.~~ Upon termination of this agreement (or any renewal or extension hereof) or the termination of the relationship contemplated hereby, between (ol. 127) Licensor, and Licensee (or their respective assigns) or in the event that Licensee's school shall be permanently discontinued, Licensor shall account to Licensee within fourteen (14) months after the happening of either of such events for the fund remaining in Licensor's hands, if any, and shall pay to Licensee the amount remaining on hand after deducting: (1) all debts and obligations due Licensor; (2) all sums due Licensor's other Licensees for redemption of lessons sold by Licensee to Licensee's pupils; (3) any payments Licensor may have made or expenses or liability incurred as a result of claims or litigations against Licensor arising out of Licensee's conduct of the enterprise contemplated hereby and (4) two dollars per hour for all lessons for which Licensee has been paid but which are still unused; which amount shall be retained by and become the property of Licensor, subject, however, to the liability of Licensor to account to holders of unused lessons sold by Licensee, to the extent of the amount retained by Licensor under provision (4) hereof. Licensor is authorized to adjust and pay any such claims or settle any such litigation, on such terms as Licensor deems advisable. Final payments to Licensee and periodic accountings shall be made by Licensor upon certification of Licensor's Certified Public Accountants, the expense of which certification, if any, shall

be charged to the funds belonging to Licensee and not by the Licensor.

See Attached Rider.

7. The Licensor and Licensee agree that it is essential to the success of the contemplated enterprise and the reputation of the Licensor, to maintain the highest standard of instruction and the highest standard of behavior among the personnel employed by Licensee. Licensee therefore agrees that the names, photographs, qualifications and references of all dancing-instructor interviewers, supervisors and other employees to be employed by the Licensee shall be submitted to the Licensor for Licensor's approval prior to employment; and that applicants must pass, to the Licensor's reasonable satisfaction, examinations in writing prepared by the Licensor and given under Licensor's supervision or direction prior to being employed by Licensee. The Licensee agrees to institute and maintain all rules of behavior and regulation [fol. 128] pertaining thereto, which are or may be established by Licensor, from time to time at the New York studio owned or supervised by Licensor. Any instructor, interviewer, supervisors or other employee hired and subsequently with or without cause, found objectionable by the Licensor, shall be dismissed forthwith at the request of the Licensor. The Licensee agrees that failure on his part to maintain adherence of his employees to the rules of behavior and the standard of instruction established by the Licensor or the failure of Licensee, in the judgment of the Licensor, to maintain Licensee's school on a level with the character and excellence of the New York studio owned or supervised by the Licensor or should the Licensee permit, allow or countenance illegal, immoral or questionable conduct on his own or on the part of any of his teachers or employees or should, in the opinion of Licensor, the reputation of the Licensee's studio be impugned, sufficient cause shall be deemed to exist to justify immediate cancellation of this license. The salaries and expenses of all dancing instructors and other employees hired, employed and engaged by the Licensee shall be borne by Licensee and not by the Licensor. Licensee agrees to require all employees

a pre-requisite to their employment to sign any contract, in the form prescribed by Licensor, which shall be uniform for all Licensees operating licensed and shall be in the form used by the New York Studio, Inc. to license, and in no other thing, the right to enforce the covenants thereof on the part of the licensee to be performed at the reasonable expense of the licensee, it being agreed to do so to Licensor's reasonable satisfaction.

The Licensee specifically agrees: (a) that he will not employ any dancing instructor, interviewer, supervisor or other employee without first obtaining the written consent of the Licensor; (b) that he will not employ any dancing instructor, interviewer or supervisor who is under the age of twenty-one years, and that, upon the Licensor's request, he will furnish the Licensor with legal proof of age of any dancing instructor, interviewer or supervisor; (c) that he will not employ any dancing instructor unless such instructor has had at least one hundred hours of private instruction in dancing at an Arthur Murray Dancing School, or has (b) attended a Teacher's Training Class at an Arthur Murray Dance Studio for at least two hundred (200) hours; (d) that he will maintain approximately the same rates of pay for his dancing instructors, interviewers and supervisors as is maintained at the New York Studio owned and supervised by Licensor, taking into consideration any special local conditions that may exist, if any; The Licensee further agrees that he will at all time require the instructor and supervisor employed by him to have a complete knowledge of all the latest Arthur Murray dance steps and Arthur Murray methods of teaching such steps and agrees that he will require his instructors and supervisors to attend classes in the latest Arthur Murray dance steps and Arthur Murray teaching methods when and as the Licensor and its representatives to the Licensee's place of business in order to teach the latest Arthur Murray steps and Arthur Murray methods of instruction to the Licensee and its instructors and supervisors. The Licensee agrees to reimburse the Licensor to the extent of not more than \$50.00 any additional cost of sending such representatives to the Licensee's studio.

Licensee further agrees, at Licensor's expense, to allow or to send the individual charged with the training and supervision of licensee's instructors to New York City to attend a seminar to be conducted by Licensor in the Arthur Murray dance steps and Arthur Murray teaching methods when notified by Licensor of the holding of such seminar, at least once in each calendar year for at least one week. Licensor will give not less than three weeks' notice of such seminars.

8. The Licensee agrees that all advertising to be placed by him in newspapers, on signs, on the radio, and on printed matter, shall first be submitted to the Licensor for Licensor's written approval before being used. Licensee agrees to approve or disapprove any such advertising within two weeks after receipt of copy or script by Licensor. The Licensee may advertise in any paper published in or over any radio station broadcasting from the territorial area in which the Licensee is licensed to do business, and until such advertising conflicts with the advertising of another Arthur Murray Licensee (of which fact Licensor [fol. 130] shall be sole judge and arbitrator as to whether any such conflict actually exists) in which case Licensee shall desist forthwith from advertising in any newspaper or over any radio station when so directed, in writing by the Licensor unless and until arrangements shall have been made, satisfactory to such Licensee and Licensor, to terminate the conflicting advertising.

The Licensee when and if called upon to do so, agree to pay his proportionate share of the cost of national advertising of the Licensor during the term of this agreement. By "national advertising" is meant advertising appearing in printed publications, on the radio, or through any other medium which is generally directed to the population of the nation rather than to some particular territory. By "proportionate share of the cost" is meant the cost allocable to the Licensee according to the ratio of the population of the territory in which this license is effective to the population of all licensed territory in the continental United States (including territory serviced by Licensees directly) based upon latest available population statistics.



Any allocation of costs entitled to by the Certified Public Accountant employed by the Licensor for such purpose shall be final and binding on the parties hereto but shall not exceed 2% of the annual gross receipts of the Licensee for the previous calendar year.

Should the gross income of Licensee for the first operating year of this contract be less than \$25,000.00 or should the gross income of the Licensee for any consecutive three months, after the end of the first operating year of this contract, be less than 90% of the gross income of the corresponding consecutive three months of the preceding year, the Licensor, at Licensor's option, shall have the right to direct the advertising of the Licensee for as long as Licensor deems such direction advisable or necessary, it being understood, however, that all expense of this advertising shall be borne and paid for by the Licensee and not by the Licensor but shall not exceed 15% of current gross monthly receipts of Licensee, it being agreed that as soon as the current gross monthly receipts again equal or exceed 90% or more of the gross receipts of the corresponding consecutive three months of the preceding year, fol. 131, Licensor will, upon request made to Licensor by Licensee, relinquish control of said advertising unless and until the gross receipts again diminish as afore-said.

9. Upon licensor's request, licensee agrees to use in his advertising, appointment cards, receipts, etc., wherever the name "Arthur Murray" appears, the following phrase:

"Arthur Murray Dance Studio

Mark & Marzalie Stevens, Licensee."

10. The Licensee agrees that he shall solely be responsible for all the expenses of the afore-said dancing school and for taxes and levies of any and all kinds in connection with said school and the income arising therefrom, and that the Licensor shall not be liable for any such expenses, taxes or levies or disbursements otherwise paid or incurred in connection with the establishment and maintenance of the afore-said dancing school, and the Licensee agrees to indemnify and hold the Licensor harmless from any and all claims, lawsuits, demands and other causes of action that

may arise or be asserted against the Licensor by reason of the establishment and maintenance of the aforesaid school or by reason of Licensee's use of the name "Arthur Murray" and all counsel fees and expenses in defending the same, and it is understood and agreed that in granting this license the Licensor does not authorize or empower the Licensee to use the name "Arthur Murray" in any other capacity than as provided herein, or to sign the name "Arthur Murray" to any contracts, documents, bills, notes, checks, drafts, leases, bonds, mortgages, bill of sale, or any other instrument in writing, or to hold himself out as a general or special agent, officer, director or partner of the Licensor, and the Licensee agrees that all contracts which he may enter into in the establishment and maintenance of said school shall be in his own name and not in the name of Arthur Murray. The Licensee, however, may state that he is doing business as such Licensee under the trade name and style of "Arthur Murray Dance Studio" during the pendency of this agreement. In addition to any other remedy, the Licensor may indefinitely itself out of the Fund set up in paragraph 6 of this agreement from any and all claims, law suits, demands and any other causes of action and the cost and expense of defending the same, as hereinbefore set forth. Counsel fees charged to Licensee shall be reasonable.

11. The Licensee agrees to obtain the Licensor's written approval of the location, layout and decoration of any school or studio to be operated by the Licensee hereunder prior to the beginning of operation therein. The Licensee agrees that it is in the mutual interest of Licensee and Licensor that the furniture, furnishings, and decorations of the Licensee's studios shall be in good taste, of high quality and character and that studios throughout the country shall be as nearly uniform in appearance as is practical and, accordingly, Licensee agrees that he will decorate and maintain his studio in accordance with the Licensor's directions. In the event that at any time the said furniture, furnishings and decorations of Licensee's studio or studios do not meet with the Licensor's approval, or that the Licensee fails to decorate and maintain his studios in accord-

agree with the Licensor's directions. Licensor shall notify Licensee of such determination and Licensee shall have 90 days in which to redecorate in accordance with the Licensor's recommendations. If Licensee's recommendations are not complied with in said period, or if Licensee by the end of said period shall not have progressed sufficiently with such redecoration to demonstrate to Licensor that the Licensee is proceeding with such redecoration in good faith and as expeditiously as possible, the Licensee hereby authorizes the Licensor to employ an interior decorator to decorate or redecorate the said studios and agrees to pay the reasonable cost of furniture, furnishings and decorations chosen by said interior decorator plus the fees of such decorator. Licensor agrees, however, that Licensee will not be called upon to expend in excess of 5% of Licensee's gross receipts for the twelve months next preceding the commencement of such redecoration without Licensee's prior written consent. The Licensee further agrees that he will install when and where practical and maintain in good order a music system of high quality and character, and shall make such change in his music system and in the kind and type of music played in his studios, as the Licensor from time to time may direct.

12. The Licensee agrees that he will make refunds to his pupils of unused lessons, at the request of any pupils for a refund when and if a refund is justified.

fol. 133) In the event that the Licensee fails to make such justifiable refund to any of his pupils, the Licensor, if convinced that such refund is justified, is authorized to make such reasonable refund as Licensor deems proper, and charge the amount so paid to the Licensee, and Licensee agrees to reimburse Licensor upon demand or Licensor may charge such payment against the deposits provided for in Paragraph 6. Licensor agrees to endeavor to keep such refunds to a minimum.

13. The Licensee shall keep true and correct books of account, employing such bookkeeping and reporting system as Licensor may from time to time direct. Among other things, there shall be entered and recorded therein the name and address of each and every dancing pupil en-

rolled in the Licensee's school, together with a statement as to the amount paid to the Licensee for dancing lessons and the number of lessons subscribed for, given and unused. The books of account of Licensee shall be open to the examination and inspection of the Licensor or Licensor's duly authorized agent during all business hours of the day. Duplicates of Social Security reports, State unemployment reports, State and Federal tax returns and any other records or accounts shall be furnished to the Licensor upon written requests. The Licensee shall pay the entire cost of establishing, maintaining and auditing his books and records, as required hereunder.

14. The Licensee shall mail to the Licensor at Licensor's address in New York on Friday of each week: (1) a full and accurate statement showing the gross receipts received by the Licensee during the preceding calendar week; (2) the names and addresses of dancing pupils enrolled during said preceding week, with complete details of their enrollment, and the amounts paid to the Licensee by dancing pupils for lessons during that week together with the names of all pupils taking lessons during said week and the number of lessons taken by each such pupil (unless such information is shown in other records required to be furnished to Licensor by Licensee); (3) duplicates of all entries made by Licensee in his books of account; (4) teacher's original time slips; (5) duplicate original slips of payments by pupils; (6) original appointment sheets and such other forms or reports as Licensor may [fol. 134] from time to time require. Said documents shall be accompanied by Licensee's check in payment of the percentage of the Licensee's aforesaid weekly gross receipts as herein set forth.

15. The Licensee shall not at any time directly or indirectly furnish any information as to the methods of instruction, interviewing, teaching, advertising, publicity, promotion ideas, or any other information relative to the Licensee's dancing school, or any dancing school, directly owned or managed by the Licensor, to anyone except the Licensor. The Licensee may, however, discuss general problems of method and management with other managers

of Arthur Murray Dancing Schools (or the Licensees operating same) but nothing hereinafter contained shall be construed to sanction the Licensee's discussion with or divulging to another person or Licensee of any information or method or advertisement or suggestion made available by the Licensor only to such of the Licensees as have shared or have agreed to share the expense of preparing or obtaining such information, method, advertisement or suggestion or which the Licensor may designate as for the exclusive information or guidance of the Licensee.

The Licensee shall not at any time directly or indirectly furnish or divulge to anyone, except the Licensor, the names of the dancing pupils enrolled in his aforesaid dancing school, nor shall he solicit their patronage for his own, or for the use of any other dancing school at any time during a period of three years after the termination of this agreement.

The Licensee shall not have any interest, financial or otherwise, in any dancing school, studio, or dance hall in any part of the United States, other than as a Licensee hereunder or in territory for which he has a license in effect from the Licensor, during the term hereof.

16. In addition to any specific rights of cancellation contained in this agreement, upon the failure of the Licensee to comply with any and all terms and conditions of this agreement, or should the Licensee for any reason whatsoever not conduct or be unable to conduct said dancing school personally and give full time and personal attention (at least) to the same for any period aggregating four months or should the Licensee, in the opinion of Licensor, neglect said dancing school the Licensor shall have the right, upon thirty days written notice, mailed to the Licensee at his address hereinabove set forth, to terminate this agreement and thirty days from the date that such notice is so mailed this agreement shall terminate and come to an end. If Licensee's failure to give full time and personal attention to said dancing school or schools is caused by bona fide illness or physical disability, said default may be cured provided and if Licensee prior to the expiration of said thirty days shall have employed a man-



ager approved in writing by Licensee, to take full and personal charge of said studio or studios.

17. The Licensee agrees that Licensee will use and advertise the name "Arthur Murray" or "Arthur Murray Dancing School" only within the territory in which he is licensed to operate and only in conjunction with the dancing schools operated by him within that territory and only in accordance with this contract and that at the termination of this agreement, he will not use the name "Arthur Murray" nor will he advertise or hold himself out in connection with any other dancing school, or while engaged in the teaching of dancing, as having formerly been connected with Arthur Murray or with an Arthur Murray Dancing School, and the Licensee further agrees that he will not, for a period of one year, following the termination of the agreement, engage directly or indirectly in his own behalf or that of any other person, firm or corporation in the City of New York or any county adjoining the County of New York or within the territory in which the Licensee is hereby licensed to use the name "Arthur Murray" or the Arthur Murray Method or within a radius of twenty-five miles of any Arthur Murray dance studio, wherever the same may be located, in teaching dancing to or soliciting the patronage of any persons who were at any time, or are pupils of the Licensor, or the Licensee, or in teaching dancing to any other persons. The Licensee admits that the Arthur Murray Method is a unique and special method of conducting a dancing school and teaching social dancing devised and developed over the course of years by Arthur Murray. The Licensee further agrees that any and all contracts made between him and his dancing instructors will be in writing and will provide that he will receive from each dancing instructor notes in payment for training and agreements similar to those signed by employees of the New York Studio or Studios and such agreements shall state that upon the termination of the contract of employment between said dancing instructor and the Licensee, said dancing instructor, while engaged in the teaching of dancing, or while connected with any other dancing school, will not advertise or hold himself or herself out as having been formerly connected with Arthur Murray or with any

Arthur Murray Dancing School, and also, an agreement in writing to the effect that upon the termination of the contract of employment between the said dancing instructor and Licensee, the said dancing instructor will not, for a period of one year following the termination of his or her employment, engage directly or indirectly in his or her own behalf, or that of any person, firm or corporation in the City of New York, or any county adjoining the County of New York, or within the territory in which the Licensee is hereby licensed to use the name "Arthur Murray" or the Arthur Murray Method or within a radius of twenty-five miles of such territory, or within a radius of twenty-five miles of any Arthur Murray dance studio, wherever the same may be located, in teaching dancing to, nor will he solicit the patronage of, any persons who at any time were or are pupils of the Licensor or the Licensee, or in teaching dancing to any other persons.

The Licensee gives the Licensor permission to use his name and photograph in all Arthur Murray advertisements, groups with other advertisers and in any and all forms of advertising and publicity. Licensee agrees to obtain the same right to use the names and photos of his instructors, supervisors and interviewers, for himself and for the Licensor and Licensee will assume full responsibility and liability for Licensor's use of the same and agrees to indemnify and hold Licensor harmless from any claim of any such employee for such use. A duplicate original of such such agreement and consent in writing between the Licensee and his dancing instructors supervisors and interviewers shall be delivered to the Licensor before the employment of instructors, supervisors or interviewers.

[fol. 137] 18. The Licensee shall not sell, transfer, assign, sublicense, mortgage or pledge this agreement or any rights or privileges accruing hereunder, to any persons, firm or corporation, without the written consent of the Licensor first had and obtained. In the event of the Licensee's bankruptcy or insolvency or adjudication as a bankrupt or insolvent under the National Bankruptcy Act, or under any other Insolvency Act, State or Federal, or if a Receiver shall be appointed by any Court of competent jurisdiction

to take possession of the property of the Licensor, this agreement shall, immediately upon the happening of such events, terminate and come to an end.

19. The Licensee shall post in a conspicuous reception room of his dancing school or studio a certificate of Arthur Murray Dance Studio License as issued by the Licensor.

20. In the event of any breach of this agreement, the Licensor shall give Licensee written notice thereof and Licensee shall have fifteen days in which to cure such breach. Such notice shall be deemed to have been delivered to Licensee forty-eight hours after it shall have been deposited in the mails with proper postage affixed, addressed to Licensee at any studio operated by Licensee.

Upon the failure of the Licensee to insist, in any more instances, upon strict performance of any one or more of the terms and conditions of this agreement, or to waive any rights hereunder, shall not be construed as a waiver thereof but the same shall continue and remain in full force and effect.

21. Licensee agrees to discharge any employee within three days after delivery of notice so to do in writing addressed by Licensee to Licensee and delivered to Licensee by Licensee to Licensee postage properly prepaid by registered mail.

22. Any failure of Licensee to cure a breach of this agreement, as aforesaid, or any failure to discharge an employee as aforesaid shall be good cause for termination of this agreement. Such termination may be effected by Licensor or by Licensee of its desire so to do in writing sent to Licensor at any studio operated by Licensee by registered mail. If, under Section 138, such termination shall be effective as of the date indicated in such written notice.

23. This agreement shall be deemed to have been made in the State of New York and shall be construed according to the laws of the State.

24. This contract supersedes all contracts in any, written or oral between the parties hereto pertaining to

the operation of dancing schools except that any monies owed by Licensee to Licensor or its predecessors under the terms of such prior contract shall be paid. Any monies held in escrow, trust or on deposit by Licensor or its predecessors pursuant to any prior contract shall be held by Licensor pursuant to the terms thereof.

25. This agreement contains the entire agreement between Licensor and Licensee, all oral agreements being merged herein, and any agreements hereafter made shall be ineffective to change, modify or discharge it in whole or in part unless such agreement is in writing and signed by the party against whom enforcement of the change, modification or discharge is sought.

26. All pronouns and any variations thereof, as used herein shall be deemed to refer to the masculine, feminine, singular, or plural as the identity of the person or persons may require.

27. This agreement shall commence as of the date hereof and shall continue for one (1) year beyond the 31st day of August next succeeding the date hereof. Thereafter the term of this ~~agreement~~ shall be automatically renewed each year for a further period of one year unless either party mails a written notice of intention not to renew, to Licensee, at Licensee's address heretofore set forth or to Licensor at Licensor's then principal place of business, by registered mail, at least thirty (30) days prior to the end of any such annual period. If such notice is so mailed the term of this agreement shall terminate as of the 31st day of August next succeeding the mailing of said notice.

28. Licensee agrees that for the first three operating years of this contract (or for each year less than three (3) years that said contract is in effect), the Licensor shall be entitled to receive on account of the percentage of gross receipts, hereby provided to be paid by Licensee, the minimum sum of \$25,000.00 with respect to each of said years. Licensor agrees, if remittances from Licensee to Licensor should total less than half of said minimum sum for any half of any of said first three operating years (or for any year less than three years that said contract is in

effect), that Licensee at Licensor's sole option, may retain this franchise only by paying the difference between the amount of remittances actually made by Licensee to Licensor for such six months operation and one half of the aforesaid minimum sum, within thirty (30) days after the close of such operating period. If Licensee fails to do so within said thirty (30) days, then Licensor may, after a (30) days' written notice by registered mail to Licensee, mailed within sixty (60) days after the end of said operating period, request Licensee to pay the difference in aforesaid or to surrender this license and to cease and desist from doing business under the name of "Arthur Murray" or any similar name, and if the Licensee, within thirty (30) days after the mailing of such written notice, fails to remit to Licensor such difference, then Licensee agrees to surrender this license and to cease and desist from doing business under the name of "Arthur Murray" or any similar name. Any sum paid by Licensee to Licensor in excess of one half of the above specified minimum sum for the first six month period in any operating year shall be credited to any deficiency below one half thereof in the second half of that operating year.

With respect to the gross receipts of the Licensee, Licensee shall be required as a minimum after the end of the third operating year of this contract, all of the Licensees which Licensees of "Arthur Murray" operate (other than New York City) shall first be ranked according to their population (on the basis of the latest official U.S. Census); then all Licensees of "Arthur Murray" who operate schools (other than New York City) shall be ranked according to their gross receipts for the operating year in question. Gross receipts and population ranking as compared by Licensor's certified public accountants shall be binding on Licensor and Licensee.

{fol. 140} If the gross receipts ranking of the Licensee is not better than three or less below the relative population ranking of the City in which the Licensee operates in any operating year after the third operating year of this contract then and in that event Licensee agrees that Licensee may, at its option, terminate his contract, as aforesaid, and Licensee agrees, at the request of the Licensor, to



surrender this license as aforesaid and to cease and desist from doing business under the name of "Arthur Murray" or any similar name.

Licensee may, however, retain this franchise, at Licensee's sole option, by paying, within thirty (30) days after the expiration of any such operating year (after the end of the third year hereof if same continues in effect for more than three years), any deficiency between the amount of the remittances actually made by Licensee and the amount necessary to be paid so that Licensee's total payments for the said operating year would entitle him to be ranked with respect to gross receipts of Arthur Murray Licensees not more than three places below the relative population ranking of the City in which the Licensee is operating for the said operating year. If Licensee fails to do so within thirty (30) days, then Licensor may, on thirty (30) days written notice by registered mail to Licensee, mailed within sixty (60) days after the end of any such operating year, request Licensee to pay such difference or to surrender this license and to cease and desist from doing business under the name of "Arthur Murray" or any similar name, and if the Licensee, within thirty (30) days after said mailing, fails to pay such difference (in the amount of such difference contained in said notice, certified to by Licensor's certified public accountant), then Licensee agrees to surrender this license and to cease and desist from doing business under the name of "Arthur Murray" or any similar name.

Nothing hereinabove contained shall be construed (provided Licensee elects to and does surrender and terminate this license and ceases to do business as aforesaid) to obligate Licensee to pay Licensor any of the aforesaid differences between payments actually made and the minimums aforesaid. If Licensor fails to give said written notice by registered mail, as aforesaid, Licensor shall be (and is) deemed to have waived its right to terminate this contract for Licensee's failure to make such minimum payment for such particular operating period or year as the case may be, without affecting Licensor's said rights with respect to any subsequent period or year.

The term "operating year" as used in this contract shall be construed to mean the year commencing on the date as of which this contract is signed without regard to the date of its termination.

29. If Licensee fails to cease and desist from doing business under the name of "Arthur Murray" or any similar name, upon any termination or cancellation hereof, it is agreed that as liquidated damages (the exact damages being difficult of ascertainment) the Licensor shall be entitled to recover from Licensee 50% of Licensee's gross receipts thereafter as long as Licensee continues to do business under the name "Arthur Murray" or any name similar thereto.

30. Sixty days after the death of the Licensee (or if the Licensee be a partnership, then after the death of the last surviving partner) this franchise shall cease and come to an end unless an administrator (temporary or permanent) or an executor or executors of the estate of the Licensee, or last survivor of the Licensees, if there be more than one, be appointed within said sixty days (60) after the death of the last survivor, and such administrator or executor within such period of time appoints a manager acceptable to the Licensor and thereafter this franchise shall terminate unless such administrator or executor (or trustee of the Licensee's legatee) continues to employ a manager satisfactory to Licensor. If any such manager proves unsatisfactory to Licensor at any time, such manager must be replaced by a manager satisfactory to Licensor within sixty (60) days after written demand by Licensor to such administrator or executor by registered mail.

31. All covenants on the part of all parties to be performed shall survive the surrender, termination or cancellation of this contract.

32. If this franchise should terminate pursuant to the terms thereof, or if it should be cancelled for any reason (fol. 142) whatsoever, and if a new written contract is entered into, or if the franchise is reinstated in writing, it is agreed, unless the parties otherwise agree, that any new franchise or reinstatement shall be "as of" the date

following such termination or the day following the effective date of such cancellation.

33. Any controversy or claim arising out of or relating to this contract, or any alleged breach hereof shall be settled by arbitration in New York City in accordance with the Rules then obtaining of the American Arbitration Association, and judgment upon the award rendered may be entered in any court of law or equity having jurisdiction of the parties or either of them.

34. Nothing herein contained shall prevent the Licensor, in a proper case, from applying to and obtaining from any court having jurisdiction, a writ of attachment, a writ of assistance, a receiver and or other relief for the purpose of preserving the status quo of and or protecting the enterprise contemplated hereby, pending the rendering down of a decision or award pursuant to the arbitration clause contained herein.

In Witness Whereof, the parties hereto have set their hands and seals as of the day and year first above written.

Arthur Murray, Inc., By: Arthur Murray, Mark E. Stevens, Marzahn Stevens (4. S.)

State of New York, / ss.  
County of New York

On the 29 day of April, 1947, before me personally came Arthur Murray to be known, who being by me duly sworn, did depose and say, that he resides in \_\_\_\_\_; that he is the \_\_\_\_\_ of Arthur Murray, Inc., the corporation described in and which executed the foregoing instrument; that he knows the seal of said corporation; that the seal affixed to said instrument is such corporate seal; that it was so affixed by order of the [fol. 143] Board of Directors of said corporation, and that he signed his name thereto by like order.

Edward G. Siegel

Notary Public in the State of New York  
Residing in Queens County

N. Y. Co. Clk's No. 1205, Reg. No. 1818-S 9

Queens County Clerk's No. 1986

Commission Expires March 30, 1949

State of Nebraska }  
County of Douglas } ss.

On this 16 day of June, 1946, before me personally appeared Mark E. Stevens and Marzalie Stevens, known and known to me to be the individuals described in and who executed the foregoing instrument, and they duly acknowledged to me that they executed the same.

Myrtle Skraggs,  
Notary Public

This rider is substituted for sentences crossed out in lines 11 to 14 inclusive in Paragraph 6 of the Agreement between Arthur Murray, Inc., and Mark E. Stevens and Marzalie Stevens, attached hereto and made a part hereof.

"Such payments shall continue until the Licensee has deposited the total sum of \$20,000.00 with the Licensee Escrow Fund, unless said fund is depleted by payments therefrom, in which case payments shall be continued or resumed by Licensee at said rate until said Fund amounts to the sum of \$20,000.00."

"Arthur Murray" Inc. and Mark E. Stevens and Marzalie Stevens, Omaha, Nebraska.

Franchise Agreement.

[fol. 144] By Mr. Bauersfeld:

Q. Does Arthur Murray, Inc., exercise any control over the operation of the local franchise?

A. They exercise considerable control; all operating policies and procedures are designed by Arthur Murray, Inc., and the franchised studios must operate their studios in accordance with the policies and procedures designed by Arthur Murray, Inc. Some of the specific controls that are in effect are that Arthur Murray of New York has the right to approve or reject the location of any franchised studio, it has the right to approve or disapprove interior decorations and furnishings of studios and if a studio is not up to the high standard demanded by Arthur

Murray. Arthur Murray has the right to come in and put such studio up to standard and charge such cost to the franchised studio. Insofar as training and personnel of a franchised studio are concerned, Arthur Murray has in effect a requirement that in a teacher must have 200 hours in a teaching class before being permitted to teach students on the dance floor. Arthur Murray has the right to reject or accept any persons hired by a franchised studio and at any time it so desires to require the firing of such personnel. It also has in effect a requirement as to minimum wage scales that the teachers and other employees of the studio would be paid. Insofar as the advertising and gross of the franchised studio, Arthur Murray has a requirement that if the advertising expenditures of the studio do not bear a certain relationship to the gross and provided the gross is not up to the standard demanded by Arthur Murray, Arthur Murray has the right to come in and take over the advertising program of the studio and to spend whatever money is required to get the gross up to the standard and charge such expense up to the studio. Also Arthur Murray of New York has another requirement in that the studios must attain a certain par figure of gross. This par figure is revised from time to time but if the franchised studio failed to hit this par figure the penalty thereof is an assessment of royalties on the par amount rather than on the actual gross receipts received by the franchised studio.

In addition to these requirements, each franchised studio is required to participate in all national advertising programs, all national contests. They are required to believe, attend dance seminars in New York for the purpose of keeping abreast of all new methods and developments in dance instructions. They are required to have various parties every month for the purpose of getting students together, giving them a good time, and what have you. They are required also to have several group or technique classes each week for their private students.

In addition to those requirements, there are a number of reporting requirements to Arthur Murray of New York. They have to report on a weekly basis the number of sales,



type of sale whether it be deferred plan, extension course or what have you; for each course sold they have to give the name of the student, amount of the contract, and everything pertaining to that contract. In addition to that, they have to report daily receipts by student as to the amount received from each student each day. And they have to return a time sheet for every employed individual as to the number of hours worked, amount paid each employee, et cetera. There are other requirements, but that's about all I can think of right now.

Q. What is the type of dance instruction given by the partnership?

A. It's private ballroom dance instruction.

Q. How long a period does a contract of instruction last or extend?

A. That would depend upon the amount of the course that was sold. Some courses are five hours and other courses range upward to 1,000 hours, and even some are lifetime courses. The smaller type of course may be sold and completed within the same fiscal year but a substantial number of courses that are sold, do extend beyond the fiscal year when sold.

Q. Will you explain what you mean by a lifetime course?

A. A lifetime course is where the student is entitled to basic number of lessons, which used to be 1,000 hours, or dance instruction and I believe at the present time it has been raised to 1,200 hours. In addition to the basic number of lessons they are entitled to two hours per month for the rest of their lives. Say a person is on the 1,200 hour or lifetime course, after the completion of that 1,200 hour course the student would be entitled to two hours per month for the rest of his life.

[Vol. 146] Q. Is there any benefit like parties that lifetime students may be entitled to?

A. Yes, I believe they do have lifetime parties for the lifetime student.

Q. How often?

A. I'm not sure but I believe it's twice a year. I'm not sure.

Q. Did you install the bookkeeping system for Schlubes in 1946 when they came to you?

A. Yes, Sir.

Q. Will you, in general, describe that bookkeeping system?

A. It's a complete set of double entry records maintained on the accrual system of accounting. Income is recorded in the period when earned and costs and expenses are recorded in the period when incurred. In order to understand better how the method of taking income into account when earned is done I think requires some type of understanding of the transactions actually entered into between the Studio and the student. When a contract is entered into with a student the cash price or contract price of the course is entered on the books as a charge to the student, representing his obligation to pay, and is credited to deferred income, representing the Studio's obligation to perform that service. As the service is performed, as the hours of instruction are given, the amount is transferred out of deferred income into earned income.

Q. Will you describe the books and records which are maintained under this system by the partnership?

A. Each Studio, and there are five of them, has a separate set of books, general ledger, cash receipts register, sales register, check disbursements register and general journal, and in addition thereto there are student's cards made up.

The Clerk: Petitioner's Exhibit No. 23 is marked for identification.

(The card referred to was marked as Petitioner's Exhibit No. 23, for identification.)

By Mr. Bauerfeld:

Q. Mr. Davis, I hand you Petitioner's Exhibit No. 23 for identification and ask you to identify it.

(fol. 147) A. This is the student's card that is maintained by the Studio on each course sold by the Studio.

Q. And what is kept on the individual student card?

A. The name and address of the student, the amount of the course that has been sold, the hours involved and the total contract price, and the sale also is classed as between

the original, extension or renewal type of sale. The lessons that are given to the student are recorded on the card and the date of each lesson and the teacher's name and the mere subtraction, of course, of the total hours to date from the total amount in the contract gives you the unused hours at any particular time. Also the card shows the date and the amount of each payment and the balance due on the course:

Mr. Bauersfeld: At this time, I'd like to offer in evidence Petitioner's Exhibit No. 23.

Mr. McCormick: No objection.

The Court: It will be received in evidence, Petitioner's Exhibit No. 23.

(The card referred to, heretofore marked as Petitioner's Exhibit No. 23, for identification, was received in evidence as Petitioner's Exhibit No. 23.)



fol. 119

By Mr. Bowersfeld:

Q. When a course is sold, what entries are made?

A. When a course is sold, the amount of the course is charged to the student, representing his obligation to pay the Studio and is credited to the deferred income account, representing the Studio's obligation to perform. At the same time the sale is entered into the general books of account a card is made and appropriate entries made thereon.

Q. When you refer to "Studio", in your testimony, you are referring to the partnership of Arthur Murray Dance Studios?

A. Yes, sir.

Q. By the way where are the books and records of the partnership maintained?

A. In my office.

Q. How is that partnership earned income finally determined at the end of the year?

A. Each course is completely analyzed as to the number of hours that were taught during the fiscal year. The rate per hour on that particular course and of course the amount of applicable earned income and all these courses are added and balanced and the total amount of earned income arrived at for the fiscal year and the books and records are adjusted to that analyzed figure.

Mr. Bowersfeld: I ask that this be marked as Petitioner's Exhibit No. 24.

The Court: It will be marked for identification as Petitioner's Exhibit No. 24.

(The schedule referred to was marked as Petitioner's Exhibit No. 24, for identification.)

By Mr. Bowersfeld:

Q. I hand you Petitioner's Exhibit No. 24, and ask you to identify it.

A. This is a schedule I prepared collecting the transactions affecting contract amount of deferred income and relating untaught lessons and balances at the end of each fiscal year for the years ending March 31, 1950 through



March 31, 1954. It shows the total contract amount of deferred income outstanding at the beginning of each year, it shows the total contract amount of sales made during each fiscal year, it shows the total contract amount of \$61,150 income transferred to earned income, the total amount of contracts transferred to earned income and the total contract amount earned and cancelled due to lack of activity and the contract balance of earned income at the end of each year. In addition to that, it shows the beginning number of untaught hours at the beginning of each fiscal year, the sales in hours made each year, the actual hours taught during each year and the actual number of hours cancelled each year and the balance of untaught hours at the end of each fiscal year.

Q. In effect this is a complete history of the deferred income account and the untaught hours.

A. That is right, this is a complete history of the deferred income account and the untaught hours for the entire five-year period.

Mr. Bauersfeld: I offer this document in evidence as Petitioner's Exhibit No. 24.

Mr. McCormick: It's a rather complicated schedule which we have not seen, Your Honor.

The Court: May I see it, please?

Mr. Bauersfeld: Yes, sir.

The Court: I'm assuming that this now is a schedule. I'm reading now the title of it, "Schedule reflecting transactions affecting contract amount of deferred income and relating untaught hours and balances at the end of each fiscal year." Now, it's my understanding that the witness, who is a certified public accountant, has made this statement from the books that I take it are in the courtroom. Are they?

The Witness: Yes, sir.

The Court: And of course, the statement is that they are made up according to the way the accountant thinks they should be made up and the way that the petitioner contends is correct. That, of course, does not preclude the respondent from having some different theory and if he wishes to compile a similar statement for his theory it

might be he will do so. Whether it will, I don't know. But it seems to me this is an admissible document. It does not, of course, preclude the respondent, from questioning [16], [151] the method of it and arguing the method nor would it be binding upon the Court to accept it, but on the other hand it seems to me it is evidentiary of the very point that is in litigation in this case.

Mr. McCormick: Yes, sir. I don't suppose it would be possible to reserve objection until possible after lunch until after I have had an opportunity to look at it.

The Court: You may make an objection at that time, if you wish to state one and the Court will permit you to make one. I understand this has not been furnished to you before. It will be received as Petitioner's Exhibit No. 24, subject, however, to the right of the respondent to object to it if he sees fit to urge some objection. The Court again states this is just one exhibit or just one object of evidence in the case which the Court permits because he is assured that the books and records are in the court room. Of course, they could not offer a statement of this kind unless the books and records are here. The exhibit is received as Petitioner's Exhibit No. 24, and you may proceed.

(The schedule referred to, heretofore marked as Petitioner's Exhibit No. 24, for identification, was received in evidence as Petitioner's Exhibit No. 24.)

**Schedule Reflecting Transactions Affecting Contract Amount  
of Deferred Income and Related Untaught Hours  
and Balances at the End of Each Fiscal Year**

**Arthur Murray Dance Studio—A Partnership**

	For the Fiscal Year Ending				
	March 31, 1950	March 31, 1951	March 31, 1952	March 31, 1953	March 31, 1954
Contract Amount of Deferred Income					
Balance—Beginning	\$ 37,844.61	\$ 72,911.87	\$ 106,341.70	\$ 131,413.52	\$ 152,912.88
Additions During Year	185,343.50	144,111.11	235,966.68	179,792.05	121,641.17
Contract Amount of Sales	\$ 22,477.14	\$ 122,666.17	\$ 211,688.78	\$ 291,431.57	\$ 354,911.17
Deductions					
Contract Amount Transferred to Earned Income	511,885.14	31,596.71	\$ 142,919.63	\$ 243,277.46	\$ 325,266.93
Contract Amount Unearned and Cancelled Due to Lack of Activity	21,580.73	38,926.73	66,844.83	82,217.78	112,655.76
Total Deductions	\$ 533,465.87	\$ 70,523.44	\$ 209,764.46	\$ 325,495.24	\$ 437,922.69
Balance—Ending—of Contract Amount of Deferred Income	\$ 12,367.47	\$ 180,442.51	\$ 154,617.92	\$ 235,912.33	\$ 236,621.26
Untaught Hours					
Balance—Beginning	5,767	11,141	17,186	21,188	31,478
Additions	27,145	28,217	30,637	32,619	34,353
Sales	12,682	32,473	41,637	46,353	51,186
Deductions					
Hours Taught—Transferred to Earned Income	1,173	18,141	17,661	28,173	37,541
Hours Untaught—Cancelled Due to Lack of Activity	14,212	5,619	5,111	16,541	21,186
Total Deductions	21,385	23,760	22,772	44,714	58,727
Balance—Ending—of Untaught Hours	11,420	15,698	17,186	31,198	37,816

[fol. 153]

By Mr. Bauersfeld:

Q. Does the partnership ever decrease the number of hours of a course after it is originally written for sale as a larger course?

A. Yes, sir, quite frequently it's necessary to rewrite a course for a smaller sum of money.

Q. How is this handled on the books of account when a course is reduced?

A. When a course is reduced in amount, the cancelled portion of the course is charged to deferred income, reducing the deferred-income account and credited to accounts receivable for the unpaid balance of the course, and the gain or loss is computed thereon.

Q. What entries are made when a student fails to complete his lessons?

A. When a student fails to complete his lessons, the unearned portion of the contract is eliminated from the accounts and if there is any unpaid accounts receivable of course they are credited to accounts receivable and the gain or loss computed on the cancelled contracts.

Q. During the years here involved by stipulation, paragraph XII, it has been stipulated that income as reflected in the partnership's books and returns for the fiscal years ended March 31, 1950 and March 31, 1954, includes gains or cancellations of students contracts as follows, and then there are those listed. Is that what is taken into account at that time?

A. That's right, that is the gain of cancellations over costs.

Q. Were these cash refunds ever made on any course that was cancelled?

A. Yes, sir.

Q. How were they handled on the books?

A. They were also handled in the same procedure as a charge against deferred income and the applicable accounts receivable written off and the gain or loss determined at that time.

Mr. McCormick: Your Honor, I object to the last testimony and ask that it be stricken from the record as inconsistent with the stipulation of facts. The exhibits

attached to the stipulation or facts contain contracts which specifically state that no cash refunds will be allowed. Vol. 154. The Court: Well, the contract might so provide, but if cash refunds were actually made, for the purposes of the income tax law they are made and whatever effect they have I don't know. It may be that according to the contract he wasn't bound to make any refunds but nevertheless we certainly have terms of contracts that are frequently waived. I'll overrule the objection.

By Mr. Bauersfeld:

Q. How do you determine what contracts are to be adjusted for lack of student activity?

A. For bookkeeping purposes a contract is deemed to have sufficient lack of activity on it to warrant cancellation if there has been a lack of activity on the course for more than one year. At that time the contract would be written off the books if it didn't have any activity on it for a period of one year.

Q. What would be done with the income?

A. It would be taken into account immediately as a gain on cancellation of the course.

Q. Do Mr. and Mrs. Schlude work in the business?

A. Yes, sir, quite a bit.

Q. What do they do?

A. They supervise the entire operations of the Omaha, Lincoln, Sioux City and Grand Island schools, and are of course, in the schools all the time, quite frequently even working on Sundays.

Q. Does that apply to both Mr. and Mrs. Schlude?

A. Yes, sir.

Q. How much of their time do they devote to the business?

A. I'd say all of their time.

Q. Does the partnership incur any expenses in giving a course of dancing instructions?

A. Yes, sir.

Q. What is the nature of the expenses?

A. Well, they incur instructors' salaries, other types of salaries, office salaries, advertising, royalties, music supplies, music cost, records, depreciation of teaching facilities, student parties, contests, travel and convention, rent,



heat, light, water and other occupancy expenses, insurance, taxes, professional services and other general expenses.

Q. Does the accounting system of the partnership [Vol. 155] your opinion, properly reflect the true income of the partnership?

A. Yes, sir, and it is the only system that will reflect the true income of the partnership.

Q. Why do you say it is the only system that will properly reflect the true income of the partnership?

A. It is the only system that takes income into account when earned and the related costs and expenses in the period when incurred. In other words, it's necessary under the accrual system of accounting to deduct from the income earned the cost and expenses incurred to produce that income. To take income into account for one period and the costs and expenses for another period does not properly reflect the true income. Under the actual system of accounting by the taxpayer the income is taken into account when earned and the costs and expenses in the same period so there is a true matching of expense against income so the true income can be determined.

Q. Would not you get the same result by accruing the costs and expenses against the income received?

A. No, sir. In order to compute the costs and expenses against the income received would require a great deal of estimation on the part of the accountant or bookkeeper to set up those costs on the books to offset income received. Under this system of accounting income is deferred until the costs and expenses incurred to produce that income are recorded on the books. In other words, there is nothing left to speculation, we wait until we have the known factors involved before computing the net income.

Q. Have the tax returns been prepared in accordance with the method of accounting regularly employed by the partnership in keeping the books?

A. Yes, sir.

Q. Has the system you installed in 1946 been used consistently over the years?

A. Yes, sir.

Q. Does the system of accounting employed by the partnership bear a true relation to the services rendered and the costs to be incurred by the partnership?

A. Yes, sir, there is a time relationship. Income is taken into account when the actual hours of instructions are given to the student and it is on the basis of the actual hours of instruction that the teachers are paid their total compensation. Other instruction costs are taken into account during the period which are applicable to the earned income, such as teachers' salaries, teaching supplies, depreciation of teaching facilities, student parties, and the rent and occupational expenses, taxes and insurance in connection therewith and all other instructional costs are taken into account during the period that the income is taken into account and therefore there is a direct relationship between the income reported and the services actually performed by the partnership and the cost of those services.

Q. In other words, there is no artificial or allocation of costs or expenses involved in this case?

A. No, sir.

Q. Did the partnership, during the taxable years of 1950, 1952, 1953 and 1954, have sufficient assets to cover all their liabilities in their deferred income?

A. Yes, sir, more than a sufficient amount.

Mr. Bauersfeld: We ask that this be marked as Petitioner's Exhibit No. 25.

The Court: It will be marked for identification as Petitioner's Exhibit No. 25.

(The schedule referred to was marked as Petitioner's Exhibit No. 25, for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 25 and ask you to identify it, please.

A. This is a schedule I prepared reflecting the excess of assets over liabilities at the end of each fiscal year, March 31, 1950, through March 31, 1954. It shows the total assets, cash, loans and miscellaneous receivables, investments, the Arthur Murray escrow fund, fixed assets and other assets as compared against liabilities and deferred income. In each case, for each year, there were excess assets over liabilities and deferred income and, in fact, if you take the cash amounts along with the Arthur

Murray escrow fund, those two items alone exceeded the collected amount or deferred income at the end of each fiscal year.

Q. Will you tell us what the Arthur Murray escrow fund is?

[fol. 157] A. That is a fund accumulated at the rate of five percent of gross receipts for the purpose of protecting and indemnifying Arthur Murray and to provide a source from which refunds can be made for paid and unused lessons sold.

Q. From what records was this document prepared?

A. This was prepared from the partnership records and the partners' personal bank accounts.

Q. So that included in the item of cash, it includes not only the cash in the partnership account but in the individual accounts of the partners—

A. That's correct.

Q. — at the time?

A. That's correct.

Q. Are the books and other records from which this was prepared in the courtroom?

A. Yes, sir.

Mr. Bauersfeld: I offer the document in evidence.

The Court: Do you wish to examine that, Mr. McCormick?

Mr. McCormick: Yes, sir.

The Court: Do you have a copy there for him?

Mr. McCormick: We have a copy.

The Court: All right.

Mr. McCormick: The only thing is we would like again to reserve the opportunity to object.

The Court: You mean you want to reserve as you did on the other?

Mr. McCormick: Yes, sir.

The Court: The Court will hear any objection when we reconvene this afternoon. The exhibit, Petitioner's Exhibit No. 25, is received.

(The schedule referred to, heretofore marked as Petitioner's Exhibit No. 25, for identification, was received in evidence as Petitioner's Exhibit No. 25.)

Schedule Reflecting Excess of Assets Over Liabilities at  
End of Each Fiscal Year

Arthur Murray Dance Studio—A Partnership

	March 31, 1950	March 31, 1951	March 31, 1952	March 31, 1953	March 31, 1954
<b>Assets</b>					
Cash	\$ 68,534.60	\$ 46,744.14	\$ 49,720.26	\$ 78,833.11	\$127,214.53
Loans and Miscellaneous Receivables	25.00	200.00	62.50	11,000.00	6,427.50
Investments—At Cost					26,990.00
Arthur Murray Escrow Fund	18,802.01	26,827.77	30,225.73	34,922.59	37,677.61
Fixed Assets—At Cost Less Accumulated Depreciation	9,946.93	13,753.30	15,974.94	28,035.32	36,825.59
Other Assets	77.00	77.00	77.00	152.00	182.00
Prepaid Expenses	337.39	840.51	982.09	874.78	699.64
<b>Total Assets</b>	<b>\$ 67,722.93</b>	<b>\$ 88,442.72</b>	<b>\$ 96,143.52</b>	<b>\$153,817.80</b>	<b>\$236,076.27</b>
<b>Liabilities and Deferred Income</b>					
Accounts Payable and Accrued Expenses Payable	\$ 4,038.93	\$ 4,771.68	\$ 7,331.58	\$ 7,575.40	\$ 11,933.84
Deferred Income—(Liability for Cash Received and Unearned at End of Year)	28,776.92	42,187.43	59,572.95	121,496.39	129,029.67
<b>Total Liabilities and Deferred Income</b>	<b>\$ 32,815.85</b>	<b>\$ 47,959.11</b>	<b>\$ 66,904.53</b>	<b>\$129,071.79</b>	<b>\$140,963.51</b>
<b>Net Worth</b>					
Excess of Assets Over Liabilities and Deferred Income	\$ 34,907.08	\$ 40,483.61	\$ 29,238.99	\$ 24,746.01	\$ 95,112.76

PARTNERSHIP EXHIBIT 33

[fol. 159]

By Mr. Bauersfeld:

Q. Are you familiar with the adjustments made by the Commissioner in the statutory notices of deficiency regarding deferred income account?

A. Yes, sir.

Q. Do the adjustments made in the notices of deficiency as to deferred income result in a determination of the partnership's true income?

A. I don't believe I understand the question.

Q. Do the adjustments made in the notice of deficiency to the deferred income of the partnership result in a determination of the partnership's true income?

Mr. McCormick: Your Honor, I'd like to object to that, as being—

The Court: I suppose you mean to ask him this, that—

Mr. McCormick: His opinion.

The Court: — as a certified public accountant is it his opinion that it is what you state?

Mr. Bauersfeld: Yes, sir, that is correct, Your Honor.

The Court: That is the way the respondent was going to suggest you asked it?

Mr. McCormick: Yes, sir.

The Court: Otherwise it might be termed a conclusion, but he may give his opinion.

Mr. Bauersfeld: You may answer that.

A. No, sir, it doesn't reflect properly the income, in fact it completely distorts the income.

By Mr. Bauersfeld:

Q. Why, in your opinion as a certified public accountant, do you believe that the Commissioner's adjustments distort the income?

A. Well, there are several reasons why it distorts the income. The Commissioner's method concludes that the dollar sales each year are income in the year in which the contract is signed, when the actual cancellation experience of the Studio proves that a substantial amount of these [fol. 160] contracts never will be realized as income. Secondly, the distortion of income occurs because it violates



one basic principle of the accrual method of accounting, that the income must be recorded in the same period, the same fiscal year, as are the costs and expenses incurred for the rendering of the services that produce that income. In other words, it isn't an accrual system of accounting unless you properly match your income with the costs and expenses that produce that income. Another thing I believe the Commissioner's method completely disregards is that in order to be income for any business organization, that business organization must give something of value to the customer before income can be realized. Income is not realized by the mere scratching of a pen across the surface of a contract. You have to give something. It is the teaching of the hours that create the right to the income and not the mere execution of the contract.

Q. Do I understand your testimony to be that the Commissioner's determination of income is not based upon even the actual receipt of cash?

A. No, it isn't based on the actual amount of money received, it's based on the execution of the contract whether or not cash has been received on it.

Mr. Bauersfeld: I ask that this be marked as Petitioner's Exhibit No. 26 for identification.

The Court: It will be marked for identification as Petitioner's Exhibit No. 26.

(The schedule referred to was marked as Petitioner's Exhibit No. 26 for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 26 and ask you to identify it?

A. This is a schedule I have prepared reflecting the comparison of gross income computed on the contract-executed basis with the gross income computed on the cash basis for each of the fiscal years from March 31, 1950, through March 31, 1954. It shows that the—

Q. May I interrupt you there?

A. Yes.

Q. And ask you what you mean by contract-executed basis?

[fol. 161] A. Well, for lack of a better way, that is what I call the Commissioner's method. It isn't an established, used method. I just refer to it as the contract executed basis.

Q. You will so refer to it in your future testimony here?

A. Yes, sir.

The Court: Does that represent what the Commissioner has done in his determination of the deficiency?

The Witness: Yes, sir.

The Court: All right.

The Witness: The gross income on the contract executed basis is tabulated in the first column for each year and the gross income on the cash basis—in other words, the actual cash received from lessons—is reflected in the second column. In the third column it reflects the excess on the contract executed basis of gross income; for the year ended March 31, 1950, the income on the contract executed basis exceeded the gross income \$46,069.04; for the year ended March 31, 1951, the excess amounted to \$48,448.61; for the year ended March 31, 1951, the excess amounted to \$48,200.13, and for the year ended March 31, 1953, the excess amounted to \$115,609.39, and for the year ended March 31, 1954, the excess amounted to \$80,791.54.

Mr. Bauersfeld: At this time I'd like to offer the document in evidence, Petitioner's Exhibit No. 26.

Mr. McCormick: We'd like to reserve again.

The Court: Yes, sir, you may make the same reservation. The Court will make this remark at this particular juncture, the Court does not understand that the Commissioner has undertaken to put the Petitioners on the cash basis.

Mr. McCormick: No, sir.

The Court: Apparently both concede that the Petitioner is on an accrual basis.

Mr. Bauersfeld: Yes, sir.

The Court: And as I understand it, the dispute between you is that under an accrual basis the petitioner [fol. 162] has pursued the proper method and the Commissioner has pursued the wrong method. This Exhibit makes a comparison between what the Commissioner has done and

what would have been the case if the cash basis had been used. It appears to the Court that is more or less immaterial. It may be useful from an argumentative standpoint. I don't know. But certainly it is frequently the case that income on an accrual basis might be considerably greater than it would be on the cash basis, yet that wouldn't spell anything at all if the Petitioner was on an accrual basis and had properly used the accrual basis or had not properly used it and the Commissioner had made adjustments. It would not spell anything at all. It would have showed by comparison he would have much less income on the comparison basis. I'm just leaving that open. It could only be useful at all for argumentative purposes because I don't understand the Commissioner is contending he should be on the cash basis. They both agree they should be on the accrual basis.

Mr. Bauersfeld: Your Honor stated the situation correctly. We contend and the Commissioner contends he should be on the accrual basis. However, there are certain cases where they have, as I said in my opening statement, the Commissioner hasn't specifically said at this time he was relying on the claim of right doctrine in this case. However, there is another case where they have. In no case has the Court held a taxpayer is taxable on more than the actual cash received.

The Court: The Court was wondering what the purpose would be. I understand you are both agreed it's on the accrual basis. It would be only admissible on the theory you're speaking of.

It has been received and the respondent, if he does object, may do so when we reconvene.

(The schedule referred to, heretofore marked as Petitioner's Exhibit No. 26, for identification, was received in evidence as Petitioner's Exhibit No. 26.)

## PETITIONER'S EXHIBIT 26

Schedule Reflecting Comparison of Gross Income  
Computed on Contract Executed Basis With  
Gross Income Computed on Cash Basis.

## Arthur Murray Dance Studio—A Partnership.

Fiscal Year Ended	Gross Income on Contract Executed Basis	Gross Income on Cash Basis	Contract Executed Basis Over Cash Basis
March 31, 1950 .....	\$185,933.50	\$139,864.46	\$ 46,069.04
March 31, 1951 .....	209,453.30	161,004.69	48,448.61
March 31, 1952 .....	235,396.68	187,196.55	48,200.13
March 31, 1953 .....	430,293.65	314,684.26	115,609.39
March 31, 1954 .....	452,040.70	371,249.16	80,791.54

The Court: You may now proceed with the witness.

By Mr. Bauersfeld:

Q. Does the Commissioner's determination include as income all accounts receivable?

A. Yes, sir, the inclusion of accounts receivable into income is admittedly the normal thing to do under the accrual system of accounting. However, there is a great distinction; under the accrual system of accounting it must be determined receivables in order to be included in the determination of net income and not just a memorandum of an account reflecting a total contract that might be involved. In other words, to put it a different way, you might refer to it as a contractor here in the city of Omaha might receive a \$2,000,000.00 contract. He may book that contract immediately upon signing of that contract and debit contracts receivable and credit reserve for incomplete contracts. However, that is not earned receivables and would not be earned income at that time. That might take three years to complete and there would be earned billings during the three year period those would be earned. You could

compare it to a company who has received some back orders for merchandise yet to be delivered or to be manufactured. (fol. 164) Those orders could also be placed on the books as an asset and a credit to reserve for uncompleted orders. However, that is not a good account receivable, it's merely setting up the contract on the books so you have control of those contracts so that later down the line you know what you have to work with. They are by no stretch of the imagination an earned account receivable.

Mr. McCormick: Your Honor, do I understand this gentleman's testimony the same as you do, that it's all related to his opinion?

The Court: Yes, the Court understands it. I think I understand the illustrations that the accountant has in mind as to the difference in accounts receivable. For example, if an automobile dealer in Omaha, Nebraska, makes a sale of a car for \$2,000.00, that's a completed transaction. It may be it's payable over 24 months or 36 months but on the accrual basis he would accrue the entire account then and there and this witness concedes that is an account receivable, that all accounts receivable of that kind goes into accrued income. But he states that in his opinion that as in this Arthur Murray Dance Studio there is a contract to give a certain number of dance lessons for a certain amount, that that is not like the sale of goods. It's an agreement to render services and only such services as were rendered in the taxable year would be subject to accrual. Is that correct?

Mr. Bowersfeld: That's correct, sir.

The Court: Yes. Of course, that is an expert opinion.

Mr. McCormick: Yes, Sir. I just wondered if it was understood on the record.

The Court: Well, the Court understands perfectly well. The Court also understands that there are a good many income tax transactions which do not comply with good accounting. He also understands that but he is not passing on this. In other words, income taxes don't always square up with good accounting. I'm not passing on this case at all, but it's perfectly proper, I think, for the witness to give the testimony he has given. As I understand it, that is the substance of it. This is not a case of an auto-



mobile salesman or hardware merchant selling merchandise, even though they may be payable in two or three or four [fol. 165] years, nevertheless they have to be accrued. On the other hand, he says this is entirely different. This is not the sale of goods but the sale of services. That makes a difference, as I understand it, from the viewpoint of the accounting witness.

Is there anything else you want to ask?

Mr. Bauersfeld: Yes. I haven't completed my examination.

The Court: Yes. All right.

Mr. Bauersfeld: May I have this marked as Petitioner's Exhibit No. 27.

The Court: It will be marked for identification as Petitioner's Exhibit No. 27.

(The schedule referred to was marked as Petitioner's Exhibit No. 27, for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 27 and ask you to identify it.

A. This is a schedule I prepared reflecting the dollar amount of executed contracts cancelled and relating to the uncollectible students accounts receivable or contracts cancelled for each of the fiscal years ended March 31, 1950, through March 31, 1954.

The Court: And these were made from books and records that are in the courtroom?

The Witness: Yes, sir.

By Mr. Bauersfeld:

Q. What do the columns show? Will you explain the schedule?

A. The first column is headed "dollar amount of executed contracts cancelled" and the second column is headed "uncollectible accounts receivable on contracts cancelled". In other words, to take the fiscal year ended March 31, 1954, as an illustration, the total amount of contracts cancelled during that year amounted to \$113,975.76. That is the total

unearned portion of the contracts that were cancelled during that year because of lack of student activity thereon. On those contracts that were cancelled, there was an unpaid [fol. 166] balance amounting to \$85,527.15. The difference between those two figures would represent the gain on cancellations for that particular year.

Q. And the gain on cancellations again is the figure that is set forth in paragraph XII of the stipulation of facts and this in the year ended March 31, 1954, would be \$28,448.61?

A. Yes, sir, that is correct.

Q. And that amount was taken into income on the cancellations in 1954?

A. Yes, sir.

The Court: By the taxpayer?

By Mr. Bainersfeld:

Q. By the taxpayer?

A. Yes, that's correct.

The Court: That Petitioner's Exhibit No. 27, have you examined it, Mr. McCormick?

Mr. McCormick: Yes, I'd like to reserve on that one also.

The Court: All right, it will be received, Petitioner's Exhibit No. 27.

(The schedule referred to, heretofore marked as Petitioner's Evidence No. 27, for identification, was received in evidence as Petitioner's Exhibit No. 27.)

# PETITIONER'S EXHIBIT 27

Schedule Reflecting Dollar Amount of Executed Contracts  
Cancelled and Related Uncollectible Students Ac-  
counts Receivable on Contracts Cancelled.

Arthur Murray Dance Studio—A Partnership.

Fiscal Year Ended	Dollar Amount of Executed Contracts Cancelled	Uncollectible Accounts Receivable on Contracts Cancelled
March 31, 1950	\$ 31,580.53	\$ 26,203.00
March 31, 1951	38,926.73	28,929.29
March 31, 1952	66,844.83	39,982.43
March 31, 1953	82,217.78	62,784.42
March 31, 1954	143,975.76	85,527.15

[fol. 167] Mr. Bauersfeld: I ask that this document be  
Petitioner's Exhibit for identification No. 28.

The Court: It will be marked for identification as Peti-  
tioner's Exhibit No. 28.

(The schedule referred to was marked as Petitioner's  
Exhibit No. 28, for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 28 and ask you  
to identify it.

A. This is a schedule I prepared reflecting the results  
of the Commissioner's determination of gross income on  
contracts executed basis for the fiscal years ended March  
31, 1950, through March 31, 1954. The schedule for the  
determination of net income reflects the total dollar sales  
made during each of those years from those dollar sales  
we have deducted expenses as shown by the partnership  
and have in addition deducted the bad debts during each  
of those years that the Commissioner has automatically  
allowed by picking up the net increase in deferred income  
and arriving at the net taxable income for each of the

years on the so-called contract executed basis. The lower half of the schedule is headed up "cash receipts and disbursements statement" and actually shows the impossible situation that would result if the Commissioner's method of reporting income was to be sustained. For each of the years we have the amount of cash receipts and deducted from the cash receipts the amount of operating expenses paid by the partnership and the escrow funds paid to Arthur Murray and acquisition of fixed assets and the income-tax costs that would be paid on that basis of determining income. For the year ending March 31, 1950, there would be a cash deficit of \$5,121.14; for the year ending March 31, 1951, there would be a cash deficit of \$11,768.42; for the year ending March 31, 1952, there would be a cash surplus of \$8,844.02; for the year ending March 31, 1953, there would be a cash deficit of \$22,632.49; for the year ending March 31, 1954, there would be a cash surplus of \$15,418.11. For the five-year period from April 1, 1949 through March 31, 1954, there would be an accumulated cash deficit of \$15,259.92 if the Commissioner's method of [fol. 168] determining income and the resulting income tax on that income were paid.

Also, I'd like to note this, it will be noted in each of these cases the sales for each of these years has actually increased, and that if the sales, for instance, for the year ending March 31, 1954, had decreased the result for that five-year period would have been greater.

Q. From what did you prepare this schedule?

A. Well, the sales, of course, are shown on the books of account.

Q. Were these prepared from the books of account?

A. That's right. Every single item on here is reflected by the books of account, with the exception of the income-tax costs which were calculated.

Q. I notice it is computed at the 1954 tax levels?

A. Yes, I believe that to be somewhat conservative insofar as the 1954 rates were somewhat less than in earlier years.

**Schedule Reflecting Result of Commissioner's Determination  
of Gross Income on Contract Executed Basis**

**Arthur Murray Dance Studio - A Partnership**

	Fiscal Years Ended				
	March 31, 1950	March 31, 1951	March 31, 1952	March 31, 1953	March 31, 1954
Determination of Net Income	\$185,937.50	\$209,453.30	\$235,396.68	\$430,293.65	\$452,047.50
Gross Income—Sales					
Operating Expenses	\$106,543.90	\$123,351.31	\$137,267.91	\$223,390.69	\$301,609.76
Expenses—Per Partnership Return	26,207.60	28,929.24	39,983.43	62,734.12	85,527.15
Bad Debts					
Total Operating Expenses	\$132,751.50	\$152,280.55	\$177,251.34	\$286,124.81	\$387,136.91
Net Taxable Income	\$ 53,186.00	\$ 57,172.75	\$ 58,145.34	\$144,168.84	\$ 64,910.59
Income Tax Cost					
Computed at 1954 Tax Rates	\$ 20,881.00	\$ 23,323.00	\$ 28,920.00	\$ 8,534.51	\$ 8,116.00
Cash Receipts and Disbursements					
Cash Receipts	\$139,841.40	\$161,004.60	\$187,190.55	\$314,684.26	\$324,249.16
Cash Disbursements					
Operating Expenses Per Partnership Return Reduced by Depreciation	\$101,363.94	\$118,589.54	\$130,133.53	\$215,383.68	\$280,750.66
Partners Salaries	14,653.33	14,266.67	14,560.00	14,560.00	14,560.00
Escrow Fund Payments to Arthur Murray	7,181.50	8,925.76	3,297.96	4,690.86	2,755.02
Acquisition of Fixed Assets	965.83	8,568.14	6,335.04	16,841.70	21,409.77
Income Tax Costs—(Per Above)	20,881.00	23,323.00	28,920.00	8,534.51	7,816.00
Total Disbursements	\$ 44,985.60	\$172,773.11	\$178,352.53	\$437,316.75	\$ 78,316.45
Balance (Deficit)	(\$ 5,121.14)	(\$ 11,768.42)	(\$ 8,844.02)	\$ 22,632.40	\$ 15,418.11
Accumulative Cash Deficit	(\$ 5,121.14)	(\$ 16,889.56)	(\$ 8,045.54)	(\$ 39,678.63)	(\$ 15,259.52)



[Vol. 170] Mr. McCormick: Subject to our reservations.

The Court: I understand when we reconvene you may state your objection to any of these exhibits that are now being received and the Court will consider them at that time.

Mr. Bauersfeld: I ask that this be marked as Petitioner's Exhibit for identification No. 29.

The Court: It will be marked for identification as Petitioner's Exhibit No. 29.

(The schedule referred to was marked as Petitioner's Exhibit No. 29, for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 29 and ask you to identify it, please.

A. This is a schedule I prepared reflecting items of income comprising the closing income reported on the partnership tax returns. In other words, for each of the fiscal years—March 31, 1950 through March 31, 1954—it's merely a classification and breakdown of the income items on the partnership return.

The Court: It does represent the income that the partnership returned in those particular years?

The Witness: Yes, sir.

The Court: You have broken it down?

The Witness: That's right.

The Court: All right, it will be received as Petitioner's Exhibit No. 29.

(The schedule referred to, heretofore marked as Petitioner's Exhibit No. 29, for identification, was received in evidence as Petitioner's Exhibit No. 29.)

**Schedule Reflecting Items of Income Comprising Gross  
Income Reported on Partnership Tax Returns.**

**Arthur Murray Dance Studio - A Partnership.**

	Fiscal Years Ended				
	March 31, 1950	March 31, 1951	March 31, 1952	March 31, 1953	March 31, 1954
<b>Items of Gross Income</b>					
Earned Income From Teaching of Dance Lessons	\$119,585.14	\$136,596.74	\$143,949.63	\$243,277.46	\$225,266.97
Gain Received From Cancellation of Inactive Courses	5,376.93	9,997.44	26,861.40	19,483.36	28,448.61
Income Received From Other Arthur Murray Dance Studios on Transfer Hours				1,065.15	2,020.57
Income Received From Contests Derby Fees & Prizes				820.00	3,630.19
Income Received From Advertising Rebate	623.37			1,441.98	2,638.45
Income Received From Budget Plan Interest, etc.	760.90	882.69	4,041.21	8,098.50	8,722.86
Income Received From Investments					574.24
Miscellaneous Income	14.00	91.32			
Income Received From Special Class Courses		994.00			
	<u>\$126,360.34</u>	<u>\$148,563.16</u>	<u>\$174,852.24</u>	<u>\$274,187.05</u>	<u>\$370,702.89</u>

[fol. 172] Mr. Bauersfeld: I ask that this be marked Petitioner's Exhibit for identification No. 30.

The Court: It will be marked for identification as Petitioner's Exhibit No. 30.

(The schedule referred to was marked as Petitioner's Exhibit No. 30, for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 30 and ask you to identify it, please.

A. This is a schedule I prepared reflecting the aging of deferred income balances at the end of each fiscal year of sale for each of the fiscal years ended March 31, 1951 through March 31, 1954. Since classification of this aging of deferred income balances is based on the total contract deferred income less the students' accounts receivable thereon. In other words, for the year ended March 31, 1954, the total amount of deferred income receivables amounted to \$163,503.20, of which the sum of \$34,869.21 was sold prior to the beginning of the year. In other words, the amount sold prior to the beginning of the fiscal year represented 21.3 percent of total income outstanding at the end of the year so most of the deferred income does represent the current year's sales. The amount that was previous to the beginning of each year for each one of these fiscal years is 19.7 percent for the year 1951 and 19.6 percent for the year ended March 31, 1952 and 13.7 percent for the year ended March 31, 1953.

The Court: All right; it will be received as Petitioner's Exhibit No. 30, subject to the right of respondent to object later, if he sees fit.

(The schedule referred to heretofore marked as Petitioner's Exhibit No. 30, for identification, was received in evidence as Petitioner's Exhibit No. 30.)

[fol. 173]

## PETITIONER'S EXHIBIT 30

## Schedule Reflecting Aging of Deferred Income Balances at End of Each Fiscal Year by Year of Sale

Arthur Murray Dance Studio - A Partnership

Period of Sale	For the Fiscal Year Ended			
	March 31 1951	March 31 1952	March 31 1953	March 1954
March	\$ 1,206.23	\$ 4,553.90	\$ 6,712.00	\$ 5,470.00
February	6,641.50	15,410.00	18,337.39	11,918.27
January	2,519.00	5,091.00	14,296.18	11,584.00
December, November, October & September	11,040.00	17,150.00	31,541.00	47,689.60
August, July, June, May and April	1,700.00	9,727.00	13,951.00	14,924.00
Previous to Beginning of Each Year	10,112.70	150.00	7,167.00	11,569.21
Total Contract Deferred Income				
Less Balance of Students Ac- counts Receivable	\$ 51,299.41	\$ 67,516.80	\$ 149,744.09	\$ 163,156.28
Less Reserve Fund (distributed as to Withdrawals)	1,112.25	7,942.00	7,747.61	14,522.11
Net Cash Balance of Deferred In- come	\$ 49,187.14	\$ 59,672.90	\$ 131,996.39	\$ 149,079.90
Percent of Deferred Income Balance Sold Prior to Beginning of Each Year To Total Deferred Income at End of Year	20	12.5	13.75	21.00

Mr. Bauersfeld: May this be marked as Petitioner's Exhibit No. 31.

The Court: It will be marked for identification as Petitioner's Exhibit No. 31.

(The schedule referred to was marked as Petitioner's Exhibit No. 31, for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 31 and ask you to identify it, please.

A. This is a schedule I prepared reflecting the effect of different accounting methods on net taxable income as between the contract executed basis and the accrual basis.

(fol. 174) I beg your pardon, that is for each fiscal year from March 31, 1950 through March 31, 1954. The upper half of this exhibit refers to the contract executed basis wherein the taxable income was computed for each of those years, and I'd like to call your attention particularly to the year ended March 31, 1953 as compared to the year ended March 31, 1954. It shows that although sales increased from \$439,293.65 to \$452,949.79, or a five percent increase in sales, that the net profit for the year ended March 31, 1954, was only 45 percent of the profit in 1953. This is on the contract executed basis. Now, going down to the accrual basis, which is the lower half of the schedule the gross income is comprised of earned income and gain on cancellations; it shows the gross income increased 34.6 percent for the year ended March 31, 1954 over March 31, 1953, and that the net profit on that basis increased 23.3 percent. In other words, on the contract executed basis for these two years it shows an absolute distortion of income with the lack of cost being properly matched against the income and the effect of practically no provision for costs incurred to produce that income, whereas under the accrual basis expense does exist and they are more in line.

Q. Will you explain the bad debts on that schedule?

A. The bad debts are those amounts that are actually charged off as uncollectible on the books of account. When the Commissioner picks up just the net increase in deferred income he is in effect saying that sales represent gross income but we will allow you this bad debt deduction. That's what this statement shows.

Mr. Bancersfeld: I offer the document in evidence.

The Court: It will be received in evidence as Petitioner's Exhibit No. 31.

(The schedule referred to, heretofore marked as Petitioner's Exhibit No. 31, for identification, was received in evidence as Petitioner's Exhibit No. 31.)

**Schedule Reflecting Effect of Different Accounting Methods  
on Net Taxable Income as Between Contract  
Executed Basis and Accrual Basis.**

**Arthur Murray Dance Studio - A Partnership**

	Fiscal Years Ended				
	March 31 1950	March 31 1951	March 31 1952	March 31 1953	March 31 1954
Contract - Executed Basis -					
Gross Income - Sales	\$185,933.50	\$200,727.98	\$211,490.00	\$208,293.00	\$211,490.00
Operating Expenses	\$106,543.90	\$123,651.31	\$137,267.91	\$123,120.00	\$123,120.00
Expenses - Per Partnership Return	26,204.60	28,929.20	29,983.47	62,734.42	53,527.00
Bad Debts					
Total Operating Expenses	\$132,748.50	\$152,580.51	\$167,251.38	\$185,854.42	\$176,647.00
Net Taxable Income	\$53,185.00	\$48,147.47	\$44,238.62	\$22,438.58	\$34,843.00
% of Expenses Per Partnership Return to					
Gross Income	14.37%	14.41%	13.80%	29.87%	25.31%
% of Bad Debts to Gross Income	14.10%	14.41%	13.80%	29.87%	25.31%
% of Taxable Income to Gross Income	28.67%	24.03%	21.00%	10.78%	16.21%
% of Sales to Sales of Previous Year		112.63%	110.27%	97.14%	100.00%
% of Taxable Income to Taxable Income of		107.52%	114.77%	127.94%	100.00%
Previous Year					
Accrual Basis -					
Gross Income (Comprised of Earned and Gain					
on Cancellations)	\$124,882.07	\$146,534.18	\$176,811.01	\$262,160.82	\$252,717.00
Operating Expenses - Per Return	106,543.90	123,351.31	137,267.91	123,120.00	123,120.00
Net Taxable Income	\$18,338.17	\$23,182.87	\$39,543.10	\$139,040.82	\$129,597.00
% of Operating Expenses to Gross Income	85.37%	84.26%	77.74%	47.00%	48.75%
% of Taxable Income to Gross Income	14.73%	15.95%	22.43%	53.03%	51.28%
% of Gross Income to Gross Income of Pre-		113.30%	116.57%	212.14%	100.00%
vious Year					
% of Taxable Income to Taxable Income of		126.20%	168.77%	136.43%	100.00%
Previous Year					

FEDERAL INCOME TAX



[fol. 176] Mr. Bauersfeld: Will you indulge me just a moment, Your Honor?

The Court: Yes, sir. Off the record.

(Discussion off the record.)

The Court: On the record.

By Mr. Bauersfeld:

Q. Supposing a student enters into a contract with the partnership here involved but is transferred to another city, for example Denver, Colorado, where there is, I understand, another Arthur Murray Dance Studio. Can he make arrangements to complete his contract at the latter?

A. Yes, sir, the Denver Studio would complete the course for him.

Q. What are the financial arrangements between Studios in that event?

A. The Denver Studio would bill the Omaha Studio for so much money for teaching out these lessons on that particular transfer student and then the Omaha Studio would write a check for that amount so billed.

Mr. Bauersfeld: That's all. The witness is submitted for cross examination.

The Court: We'll now recess until two o'clock.

(Whereupon, at 12 noon, a recess was taken until 2:00 p. m. of the same day.)

#### Afternoon Session

2:00 p. m.

The Court: All right, you can resume the stand now. I believe you had finished?

Mr. Bauersfeld: Yes, Your Honor.

The Court: You may then proceed, Mr. McCormick.

ROBERT J. DAVIS resumed his testimony as follows:

Cross examination.

By Mr. McCormick:

Q. Mr. Davis, you testified that certain notes were taken to the bank, notes such as Exhibit No. 21-A, which is at fol. 177, attached to the Stipulation of Facts. Now, when the Studio, the partnership did that, did take such a note as that to the bank they would endorse the note on the back, would they not?

A. It was endorsed with complete recourse.

Q. I see. When you testified with respect to the reserve that the bank sets up on a note which is taken to the bank you stated that the note was not or the reserve was not available for use. You meant only until or not available to use until the note was fully paid, did you not?

A. That's right, in other words, the student had to make the final payment on the contract before the reserve funds on that particular contract would be released.

Q. There was only one general partnership bank account, was there not?

A. There actually were several bank accounts but they were all general in nature.

Q. One of those was in the First National Bank of Omaha, is that right?

A. Yes, sir, that's right.

Q. And cash collections from students and from the Bank from discounted notes and from the Bank from reserve funds after the notes were fully paid were either deposited or credited to this partnership general bank account or one of the partnership general bank accounts, is that not correct?

A. If I understand your question correctly I believe your statement is correct. In other words, the proceeds from the notes when they were originally transferred to the Bank and also at the end of the note's life, when the student had paid it up, were those funds transferred to the partnership general bank account?

Q. Yes.

A. Yes, sir, they were.

Q. Those bank accounts were used to pay the expenses of the partnership?

A. Yes, sir.

Q. The Bank did not restrict in any way the use of the funds in the general bank account?

A. Not in the general bank account, no.

Q. What was the royalty percentage agreement with Arthur Murray of New York?

A. The royalty percentage varied in rate according to the particular Studio. For Omaha the rate was 10 percent and was applied to the gross receipts received by the Studio.

[fol. 178] Q. Not the total sales?

A. Oh, no, sir. The royalty was applied to the actual money that went into the partnership's general bank accounts. That's what they paid royalty on.

Q. How about on the reserve?

A. No, sir, there was no royalty paid on the reserve fund until it was taken out of reserve fund and went into the general bank account.

Q. When was this paid, this percentage royalty paid to Arthur Murray of New York?

A. Every week.

Q. That was deducted on the return of the year in which paid?

A. Yes, sir.

Q. Now, what was the commission arrangement with sales personnel for selling lessons?

A. Well, that varied to a considerable extent. The general commission arrangement, for instance, on a deferred payment plan that went through on the first half of the deferred payment plan. In other words on the first 50 percent the Studio received from the Bank there would be a commission paid on the first 50 percent and then when the note had matured and the money was taken out of the reserve fund and transferred to the general bank account then the commission was also paid on that portion of it at that time. In addition to that, the commissions were on somewhat of a continuing basis. In other words, if a sales person sold a course say for \$500.00 cash then they

would be paid on the basis of perhaps \$10.00 a week perhaps for the next four or five weeks on that sale.

Q. Now, as I understand you 50 percent was received from the Bank, that 50 percent of the commission due would be paid at that time.

A. That's right, 50 percent of the total commission would be paid at that time.

Q. That would be deducted on the return for the year in which paid?

A. That's correct.

Q. I'd like to show you what we have stipulated as Exhibit No. 14 N, which I think you are familiar with as having helped in the preparation thereof and I'd like for you just to clarify the fact that the items here described as deferred income collected, in the last two items on the schedule, means deferred income cash collections, if that is true?

A. There are two tabulations here under the general fol. 179 heading of deferred income collected. The first tabulation on deferred income collected is on the assumption, in other words the words are "considering reserve fund held by Bank as collected". I believe that is the Commissioner's part on this schedule, that they are assuming that the cash is collected on the reserve fund. The bottom half of the schedule "deferred income collected considering reserve fund held by Bank as not collected until funds are released and made available for withdrawal by Bank". The difference between the two, of course, represents the reserve fund held by the Bank.

Q. Yes. I just wanted for you to show clearly that the word "cash collections" is what is meant in both of the items.

A. On the two different questions that are involved, that is right.

Q. Yes, sir. You testified that the Studio was required to give parties. Was that to encourage sales and to help in the sales program?

A. That would have nothing to do with obtaining sales, no, sir. That's the obligation of the Studio to give those parties to the students that they have already enrolled, that are their present customers.

Q. Would the total amount of those expenses for giving these parties be deducted in the year in which they were paid?

A. Yes, sir.

Q. You testified with regard to transferring a certain amount to earned income as lessons were given. How did you determine exactly how much to transfer?

A. On the basis of the actual number of hours taught on each particular course.

Q. How did you determine the exact amount?

A. By multiplying the rate per hour in each course times the hours involved in that particular course, each course. Of course, some courses are at different rates per hour. As I said before, they range from five hours up to 1,000 hours and better so each course has a different hourly rate attached to it so we determine the actual earned income on each course for that particular fiscal year.

Q. You mentioned that the refunds were made to students. What was the exact amount of those refunds in the years ended March 31, 1950, 1952, 1953 and 1954?

[fol. 180] A. I don't know.

Q. Isn't it true, Mr. Davis, in fact that the partnership discouraged refunds?

A. That is true.

Q. Isn't the amount of the refunds given, isn't that shown in the books?

A. Yes, sir.

Q. Do you have the books here in which you could show us?

A. The books are in the courtroom, yes, sir.

Q. Could you show us them from the books?

A. We could dig it out. They happen every year. It would be a matter of picking out the months and so forth those refunds were made.

Mr. McCormick: If the Court would permit the time, I think that would be important.

The Court: Well, Mr. McCormick, I think if they are not in certain accounts so that they can easily be identified that might be a very troublesome procedure. If you have,

for example, let us say. I believe the first fiscal year was the fiscal year of 1950, was it?

The Witness: Yes, sir.

The Court: If you have an account on the books for that year that shows in detail the refunds, I think that wouldn't be very troublesome to get an explanation how it was done. Do you have any such account?

The Witness: No, sir, there is no account in the book headed "refunds". We'd have to go through the check register and dig out the checks.

The Court: You had no account you carried on the books so when a refund was made you would record it in a certain account?

The Witness: The refunds were generally, I'd say, charged to deferred income.

The Court: For which?

The Witness: There is an account in the books.

The Court: I didn't quite understand.

The Witness: I said the refunds were charged generally to an account headed deferred income.

The Court: Yes. There again you would have to search them out, I suppose.

Q. 181. The Witness: Pretty much so, yes, sir.

The Court: How were they figured on the income tax return? I suppose on that deferred income?

The Witness: Gain on cancellations was determined after that refund in considering the unpaid balance, of course, and the unearned portion of the contract. Gain on cancellations was computed and reported on courses cancelled.

The Court: What counsel is now asking would probably be rather difficult matter to answer. As I understand it, in effect what he is asking you is for the first fiscal year, your question is, Mr. McCormick, how much refunds were made in that fiscal year?

Mr. McCormick: Yes, sir.

The Court: In order to answer that you say you would have to go through the cash disbursements books?

The Witness: Yes, sir, I'd have to go through the books. Since it didn't actually have any bearing on the account.



ing method employed by the taxpayer there wasn't any particular segregation.

The Court: Yes.

By Mr. McCormick:

Q. Well, if you had refunds to students, Mr. Davis, would it be necessary to have a gain on cancellations?

A. Well, maybe the entire amount was not refunded.

Q. Mr. Davis, these are the partnership returns for the years involved here which contain on the back of them net worth balance sheet statements?

A. Yes, sir.

Q. The figures therein seem to conflict with the figures in this net worth statement that you have submitted here as Exhibit No. 25. I was wondering if you could reconcile the differences there?

A. What particular figures are different that you want a clarification of? We know the cash is different because of the partners' personal bank accounts which were used in the preparation of Exhibit No. 25. Are you referring to the deferred income?

[fol. 182] Q. Yes, that's one thing. One of the figures I'm referring to is the deferred income.

A. The deferred income on Exhibit No. 25 is stated in the amount of cash received by the taxpayer. In other words, the deferred income shown on Exhibit No. 25 does not include the accounts receivable. In it is included only the actual amount received by the S. Co. This is the amount paid on deferred income prior to that is shown on Exhibit No. 25 whereas the deferred income shown on the partnership tax returns is the contract price.

Q. I have here the partnership returns for the year ended March 31, 1954, which is Exhibit No. 30. The balance sheet on this return shows cash at the beginning of the year of \$21,926.96 and the end of the year as \$28,106.78. Now Exhibit No. 25 shows cash at the end of the year of \$46,744.14.

A. That is correct. I have stated before we took into consideration the partners' personal bank accounts as of the end of the fiscal year in the preparation of Exhibit No. 25.

Q. And that is true with respect to all years?

A. That is correct.

Q. I hand you what has been marked as Petitioner's Exhibit No. 26. You will notice that the middle column there is entitled "gross income on an accrual basis". Does that include the amounts in the reserve fund?

A. No, sir. If I may clarify that, it includes the amounts from the reserve fund when they are released and made available and transferred to the general bank accounts.

Q. Mr. Davis, I hand you what has been marked as Petitioner's Exhibit No. 29. There is an item on this exhibit entitled cash receipts and disbursements. Cash receipts, does that item include the reserve fund in the bank at the end of the year?

A. No, sir.

Q. Mr. Davis, I show you Petitioner's Exhibit No. 31 and there are two principal headings on that exhibit, one is "contract executed basis" and the other "accrual basis". Just for clarification, the first subject, "contract executed basis", by that you mean to direct the Commissioner's conception of the accrual method basis that should be employed here?

A. It is the Commissioner's method, yes, sir.

Q. His idea also of the accrual basis, the Commissioner's conception of the accrual basis?

A. Yes, and of course you think of only one method as being the true accrual method of accounting. I don't know what the conception of the Commissioner is on this contract executed basis.

Q. That is what you are attempting to show?

A. I am showing the basis on which the Commissioner is assessing the deficiencies which they are taking into consideration in the deficiency notice, when the contract is signed, but I would not refer to it as the accrual basis of accounting.

Q. It has been agreed in this case in the pleadings that the petitioner is on the accrual basis of accounting?

A. That's correct.

Q. And that the Commissioner is not disputing that?

A. I understand they are not disputing that the method is on the accrual basis of accounting.

Q. You were merely attempting to show what the Commissioner has done?

A. I am showing the Commissioner's method of bringing at the tax deficiencies, yes, sir.

Q. You testified with regard to payments made to other Studios in other localities to cover lessons of students who had transferred to another locality and some other Studio had instructed the lessons that had originally been contracted for in Omaha or one of the branch offices?

A. Yes, sir.

Q. In the years involved here 1950, 1952, 1953 and 1954 — what was the exact amount of those payments made to other Studios?

A. Well, I don't have the figures here in front of me. I couldn't recall them.

Q. Do you have the figures in your books?

A. Yes, sir.

Q. Are those books in the courtroom?

A. Yes, sir.

Q. Could you show us, do you have an account that would show us?

A. I believe that could be shown for each particular Studio.

Mr. McCormick: Well, again, if the Court please, I think that would be a helpful item to be shown.

The Court: Well, if Mr. Davis can by referring to his books answer that question without too much searching of the books, it will be all right.

[fol. 184] The Witness: I believe I can find the information all right. I don't know how long it will take but I can find it in the books all right.

The Court: What the Court is anxious to do, of course, is to enable you to answer the inquiry. We would know readily you had five Studios, didn't you?

The Witness: Yes, sir.

The Court: You had an account with each one and each one would show the amount of refunds in some separate account. I don't think it would be hard to find but if it in a cash disbursements, it might be difficult.

The Witness: I think we have an account headed "transfers for hours." I think we can turn to for each year that may be requested.

The Court: Do you want to take a recess for about 10 minutes so that the witness can see if he can assemble that data?

Mr. McCormick: Yes, sir, and at this time I'd like to then offer no objection to the exhibits that were submitted this morning.

Mr. Baucers: All right. If the Court please, would there be a suggestion to save time, we will agree on having, after this trial, Mr. Davis make a schedule which will show this information and verify it with the agent and put it in the record so we can go on.

Mr. McCormick: Yes, that would be all right.

The Court: All right. We will agree Mr. Davis will compile this, and let the revenue agent check it at his leisure and file it.

Mr. McCormick: May that ruling also apply to the funds as well as payments to other studios?

The Court: I understand the refunds can be ascertained, perhaps not so quickly.

Mr. McCormick: All the Court please, I don't want to hold the record open forever for putting in exhibits. I will agree on this one which can be readily obtained, but it will take considerable time during Mr. Davis' busy Feb. 1950 period of making out tax returns and I would object to that.

The Court: I don't see just what the advantage of it would be anyhow. What effect does it have on the liability, that's the important thing in these years.

Mr. McCormick: Well, it shows merely that they had this money which they were going to keep for the most part, the cash collections.

The Court: As I understood it, they had certain

Mr. McCormick: It is not going to be returned.

The Court: contracts. I understood this morning that really the contracts said they were not to make any refunds but as a matter of fact they did make refunds and I assume whenever they made a refund that a deduction of some kind was made on them.

Mr. McCormick: Well, maybe we could agree then to withdraw or strike out the portion of the testimony that said that refunds were made unless we can determine the exact amount.

The Court: I imagine the Commissioner had more time, himself and his agents, to examine those books, you thoroughly.

Mr. McCormick: Well, sir, as I said, the contracts, of course, say no refunds.

The Court: What do you say?

Mr. McCormick: The contracts say no refunds.

The Court: The Court has no desire to keep out any evidence that might throw any light on the case. Now, you have agreed on the question of paying some other Studios for filling out contracts. Mr. Davis is going to get that information for you to be filed as a schedule. Now, what you would like to have is another schedule that would show the refunds. The Petitioner's objection to that is not so much to the evidence as that it will be difficult to assemble that information. They don't want to take the time. Maybe your agent could take the books and go through them and have it verified. Do you want to do that?

[Vol. 186] Mr. McCormick: Yes, sir.

Mr. Bauersfeld: Of course, Mr. Davis would have to spend the time to do it to see it was correct if the agent did it or Mr. Davis did it.

The Court: The Court is not disposed, as I say, to keep out any relevant evidence but I don't see how at this stage without the evidence being obtainable without Mr. Davis going through the books in detail. I don't think that requirement should be made of him at this time. I don't know what effect it would have on the tax liability. At the present moment I don't think it would have any. Well, as I understand it, now, you are to later file as a schedule information that will show the amount paid to these other Studios for carrying out contracts with another one. You may proceed, Mr. McCormick. The answer of the witness, as I understand it, to your general question is can he tell how much was refunded to students in these fiscal years and his answer is he doesn't have any account which shows

that, that he would have to go through the cash disbursements and check and correct it out. That couldn't be done without considerable delay of the trial.

By Mr. McCormick:

Q. As to the amounts of deferred income at the end of a particular year, Mr. Davis, isn't it true that most of the lessons which that represents will be taught within say the next 12 months?

A. Of the amount deferred at the end of any particular year, isn't that true that most of that would be taught out within the next 12 months?

Q. Yes.

A. That is correct.

Q. Now, as to arrangements with students for lessons and times, students were permitted to call up the Studio and arrange for their dates for taking their lessons, isn't that true?

A. Do you mean were the lessons made by appointment?

Q. Yes, by appointment, the time.

A. Yes, sir, they were scheduled.

Q. Schedule a lesson from time to time, say from lesson to lesson they could call up and make arrangements to take their lesson. If they took a lesson today, as far as [fol. 187] next week is concerned they could call up during the next week and arrange to take a lesson say on Thursday of next week?

A. I think it was a little bit more routine than that. When a student took a lesson on a particular day, the teacher generally schedules his next lesson before he leaves.

Q. Yes, but they would schedule it at that time. It wasn't any fixed schedule when they contracted with a student for a certain lesson on a certain day at a certain hour in the next year which the student had to abide by, was it?

A. No, sir.

Q. How long did you testify you had practiced accounting, Mr. Davis?

A. About 13 years.

Q. Excuse me, 13 years?



A. Yes.

Q. When did you receive your degree?

A. In 1948.

Q. When did you set up the books for this Studio?

A. In 1946, when I was associated with the Lewin-Lind Company, certified public accountants.

Q. When did you receive your certified public accountant rating?

A. In 1948.

Q. In 1948?

A. Yes.

Q. So that you were not certified at the time you set up this method of accounting for this Studio?

A. No, sir. That is correct.

Mr. McCormick: I believe that's all.

The Court: Have you anything else, Mr. Bauersfeld?

Mr. Bauersfeld: Will you indulge me just a moment, please, sir?

The Court: All right.

Mr. Bauersfeld: No further questions.

The Court: All right, Mr. Davis; you're excused.

(Witness excused.)

Mr. Bauersfeld: May we call the next witness?

The Court: Yes, sir, you may.

Mr. Bauersfeld: Mr. Cole.

[fol. 188] Whereupon, DANA F. Cole, called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

Direct examination.

The Clerk: State your name and your address, please.

The Witness: Dana F. Cole, 425 Stuart Building, Lincoln, Nebraska.

The Clerk: Spell your name, please, sir.

The Witness: D-a-n-a F. C-o-l-e.

The Clerk: Thank you.

By Mr. Bauersfeld:

Q. What is your profession, Mr. Cole?

A. I'm a college teacher and practicing public accountant.

Q. Where is your public accounting business located?

A. Our office is at Lincoln, Nebraska.

Q. And how long have you practiced public accounting?

A. Oh, 42 or 43 years.

Q. What is the name of your firm?

A. Darla F. Cole & Company.

Q. How many people are in your organization?

A. Oh, it ranges from 15 to 20.

Q. And what territory does your practice cover?

A. Well, it covers the practice around the Lincoln area, which is in Nebraska, northern parts of Kansas, eastern Colorado and Wyoming, western part of Iowa, it goes into Illinois and Missouri.

Q. What has been your experience in public accounting?

A. Well, I've been in general practice of public accounting since 1915. I guess, doing every type of work a public accountant might be called on to do.

Q. Where do you teach?

A. University of Nebraska.

Q. And what subjects do you teach?

A. At the present time I am teaching advanced cost accounting and income tax accounting in both introductory and advanced courses.

[fol. 189] Q. How long have you taught at the University of Nebraska?

A. I started teaching in February of 1915.

Q. What is your title at the University?

A. Professor of accounting.

Q. What subjects have you taught since 1915?

A. I have taught all the principal courses, principles of accounting, principles of cost accounting, advanced cost accounting, tax courses, which are income tax, estate taxes, gift taxes, Social Security taxes. For a while I taught the marketing courses in the field of salesmanship, marketing, advertising.

Q. Have you written any books?

A. Yes.

Q. What is the name of it?

A. Several preliminary books I wrote prior to the publication of a textbook referred to as Beginning Accounting, which was published in 1940.

Q. Where is this book used?

A. It was used in several schools and colleges throughout the country.

Q. Was it used at the University of Nebraska?

A. Yes, it was.

Q. Of what professional societies are you a member?

A. The American Accounting Association, the National Association of Accountants, American Association of University Professors, the Interprofessional Institute.

Q. What is your educational background?

A. I took my first degree at the University of Nebraska, A. B. degree, in February of 1915. At the same time then, after I started to teach accounting and went on to take my Masters Degree in June of 1916, then went on to Columbia University to continue my advanced courses, but I never did go on and take any further degrees.

Q. Have you ever testified in court as an expert accounting witness before?

A. Yes.

Q. In what court have you testified?

A. In this Court, the Tax Court, the local Federal Courts, Nebraska Courts and the Federal District Court.

Q. Have you examined the books of the partnership, Arthur Murray Dance Studio?

A. Yes, I haven't audited them but I have examined them, looked at them, I never made an audit of them.

Q. Have you read the Stipulation of Facts and the exhibits attached thereto in this case?

A. Yes.

[fol. 190] Q. Have you seen the other exhibits introduced in evidence?

A. Yes.

Q. Have you been in the courtroom and heard the evidence given so far in this case?

A. Yes.

Q. What other information would you need in order to form an opinion as to whether the books and records of

a partnership are maintained under generally accepted and sound accounting principles?

A. I think none other than what I have seen.

Q. In your opinion, are the books and records of the partnership maintained in accordance with generally accepted and sound accounting principles?

A. Yes, I think they are.

Q. Specifically, with reference to the item known as deferred income on the books, has this item been handled in accordance with generally accepted and sound accounting principles?

A. Yes, it has.

Q. Why, in your opinion, has this item known as deferred income been handled in accordance with generally accepted and sound accounting principles?

A. Well, it's certainly improper to take into income any item of income until it's earned and wrong to take in theoretical records of income or statistical records of income until that income has actually been produced and I think that is the way these books have been kept. They do record income as it is earned and not until it's earned. These books, while they have reflected a memorandum of agreement to do certain things, they have not recorded any income earned by those agreements. They have recorded a memorandum that they have perhaps created a liability but they haven't recorded any record of the fact they have earned any income at the time the contracts were entered into so I don't think there is any income in those recorded receivables at the time they are recorded and there is no income there until the studio has delivered the service they contracted to give, and for that reason I think that there is no income there until the Studio earned it and I think they have been accurately recorded as the income was earned at the time it was earned.

Q. In other words, you feel that the method of accounting employed by the partnership properly reflects its true income?

A. Yes, I do.

Q. Is the account receivables that are reflected at the [fol. 191] time the contract is entered into a true account receivable in the accrual accounting concept?

A. No, it isn't.

Q. Will you explain that?

A. All it is is a memorandum of agreement to do certain things. They record the contract that they are going to agree to deliver certain services in the future, having delivered none whatsoever at the time it is recorded on the records and it is only a memorandum of a certain type of agreement that has been entered into, and that is all you can say about the account. Actually a true account receivable is entered after the service has been rendered and not before. The ordinary concept of an account receivable or note receivable is when a firm accepts payment in that fashion for a service that has been rendered and not what they intend to do at some time in the future.

Q. Does the adjustment made to deferred income by the Commissioner result in a determination of true income of the partnership?

Mr. McCormick: In your opinion.

By Mr. Bayersfeld:

Q. In your opinion.

A. I think it doesn't.

Q. Will you explain why not?

A. Because it brings into income a record of income before any of it has been produced, at least before all of it has been produced, that while there are some cases where cash may have been collected at the time of the record made that cash that is on hand is not true and in fact is a trust fund that is on hand in this account and which they are duty bound to spend in the rendering of that future service and accountants would look at it as a true trust fund that has to be kept on hand. It reflects a liability in income on this concern to spend funds and perform in the future.

Q. Now, as a practicing public accountant could you would you certify to a financial statement prepared under the Commissioner's method of determining income?

A. I certainly would not.

Q. And why would you not?

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A. I think if an accountant would certify that those so-called items of deferred income represent net worth he would be making a false report to the banks or others [fol. 192] concerning their financial liability to carry on. If it's net worth it's there to be drawn out. If it's a corporation it's in its dividends or if it's a partnership it's there representing funds that may be drawn out for personal use and it would be a violation of their liabilities and contractual relations to their customers if that were true and it would misinform the bank concerning their ability to carry on as a growing concern and perform their business daily transacted or required to be carried on by them and I think no accountant would certify to the accuracy of a statement that did not contain these items as deferred income, either subtracted from the assets or as an inclusion in the liabilities.

Q. Would you certify to a financial statement with some qualification that was prepared under the Commissioner's method of determination?

A. No, sir, I would not. We don't prepare certified statements with qualifications.

Mr. Bauersfeld: You may inquire.

The Court: Cross-examine.

Cross examination.

By Mr. McCormick:

Q. Mr. Cole, are you a certified public accountant?

A. No, sir.

Q. You spoke of your opinion about these funds being a trust fund, are you a lawyer?

A. No, sir.

Q. With respect to your many long years of teaching, Mr. Cole, would you say that you have been pretty successful in your teaching?

A. Oh, yes.

Q. Without bragging too much.

A. I see several of my students sitting around here. They seem to be doing pretty well, and at least I've stayed with it for quite a while.



Q. Are you familiar with the fact one of the students you just referred to has been doing pretty well in the accounting field, who set up this case for the Government?

A. I always considered Mr. Berry one of my very good students. We didn't always agree, but he was a good student.

Q. In your teaching you recognize and you mentioned you teach tax accounting?

A. Yes.

[fol. 193] Q. You recognize there are many differences in tax accounting and commercial accounting?

A. Yes, I do. There are a good many places where they differ.

Mr. McCormick: I believe that's all.

Redirect examination.

By Mr. Bauersfeld:

Q. Mr. Cole, did you ever take the certified public accountant examinations?

A. No, I never did.

Mr. Bauersfeld: No further questions.

The Court: All right, Mr. Cole. Thank you, Sir.

(Witness excused.)

Mr. Bauersfeld: May Mr. Cole be excused, Your Honor?

The Court: Yes, he may be excused.

Mr. Bauersfeld: I will call Mr. Miller.

Whereupon, JAMES D. MILLER, called as a witness, and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

Direct examination.

The Clerk: Would you be seated and state your name and your address, please.

The Witness: James D. Miller, Bronxville, New York.

By Mr. Bauersfeld:

Q. Mr. Miller, what is your occupation?

A. I am a certified public accountant.

Q. How long have you been a practicing public accountant?

A. About 37 years.

Q. What is the name of your firm?

A. James D. Miller & Company.

Q. How many people are employed by your firm?

A. Well, it varies from year to year and in the course of the year it will range from 20 to 50.

[fol. 194] Q. What territory does your practice encompass?

A. Our offices are located in New York City. However, our work takes us all over the country and into some foreign countries.

Q. Have you ever performed any professional services for the United States Government?

A. Yes, I have.

Q. Will you tell us what they were?

A. During World War II we audited a portion of the President's unencumbered funds; we were also retained by the Office of Strategic Services to do all of the accounting work in connection with the renegotiation of War contracts, contract termination and cost-plus contracts and price redetermination.

Q. Now, over the period of years what has been the nature of your accounting practice?

A. Well, we have done all kinds of accounting practice, that is all types of accounting services that a certified public accountant would in the ordinary course of events be called upon to do. However, we have specialized in tax practice and in special investigations.

Q. What is your educational background?

A. I graduated from a small country high school. From there I went to preparatory school by the name of Franklin Marshall Academy. After graduating there I went on to the University of Pennsylvania. After World War I I found I needed some accounting training in the job I had at that time, so I went to night school and studied account-

ing in Pace & Pace Institute. After that I took special accounting courses at Columbia University, New York University, and City College of New York. That's all.

Q. Do you belong to any professional associations or societies?

A. Yes, I do.

Q. Which are they?

A. The New York State Society of Certified Public Accountants, the American Institute of Certified Public Accountants.

Q. Have you ever testified in court as an expert accounting witness?

A. Yes.

Q. Will you tell us the Court and the names of some of the cases in which you have been retained to testify?

A. We were retained a little over 20 years ago to do all of the accounting work and testify in the so-called Madison Anti-trust case at Madison, Wisconsin. In that case the [fol. 195] Government had brought an anti-trust action against all 22 major oil companies operating throughout the mid-western area of the United States. I testified in that case not only for the collective defendants but also for many of the individual oil companies. There were two Madison cases and we were also retained to do the accounting work and testify in the second Madison anti-trust suit. That was followed shortly after by an anti-trust action brought by the Government against all of the eight major oil companies operating on the Pacific Coast and also about 50 independent oil companies and we were retained to do all accounting work and testify in that anti-trust action.

The six major oil companies operating in the State of Wisconsin became defendants in a large triple-damage suit, conspiracy suit, and we were retained by them to do the accounting work in that suit and testify in that case.

In the anti-trust suit brought by the Government against the eight major motion-picture companies I testified in that suit.

We were also retained in other anti-trust actions. One was against the Corrugated & Solid Fiber Shipping Container Industry. We were retained to testify in the triple-damage suit brought against Ford Motor Company by

Harry Ferguson, Inc., and others. That was a \$350,000.00 action. We did accounting work for the Ford Motor Company in that case. We worked for the Ford Motor Company and testified in other suits brought against them. For instance, the All-Tight Motor Products Co., Inc., brought a triple-damage suit against them for \$10,000,000.00. We retained to testify in the triple-damage suits brought against the cigarette companies, the American Tobacco Company and Laggett & Myers. There was a \$36,000,000.00 action brought against them by the Monticello Tobacco Company. I testified for the Pathe Film Company in an accounting suit against E. I. Dupont de Nemours. I testified in a triple-damage suit brought by the Interborough News Company against Curtis Publishing Company and seven other large magazine publishers. I testified for Borg-Warner Corporation in a case brought by them against the Government of the United States in the Court of Claims. I testified in quite a few accounting suits, for instance in connection with the dissolution of the theatrical firm of Klaw & Erlanger, also [fol. 196] in a suit arising out of the liquidation of a large export and import firm by the name of Crossman & Sielkes.

In another suit in Pittsburgh brought by the Julian Kennedy Coal Industries against the Hellman Coal & Coke Company, I am testifying now in a suit in connection with the partition of the theatrical firm of Lee and J. J. Shubert. I testified before the Interstate Commerce Commission in connection with the merger of the Chesapeake & Ohio Railroad and the Pere Marquette Railroad.

We were retained to do accounting work and testify in the Bendix Aviation Corporation stockholders' derivative suit. We were retained in the anti-trust action in the Government conspiracy suit that was brought against the nine large manufacturers in the copper wire and cable industries. I was retained by various special prosecutors appointed under the Moreland Act in the State of New York in various investigations, one having to do with determining the costs and administration of the Workmen's Compensation Administration. I was retained to testify in the \$20,000,000.00 damage suit by the receivers for the Paramount-Public Corporation against its former manage-

ment. I testified in an action brought by the Securities & Exchange Commission, against the former management of the Thermoid Company.

I have been retained to testify in a triple damage case brought against the Western Auto Supply Company down in South Carolina. I testified in a large number of cases. I testified in a case involving the Half-Scott Motor Car Company out in California, the Sylvania Industrial Corporation down in Virginia, the Welcome Wagon, Inc. down in Georgia and for some movie people out in California, such as Adolph Zukor, Jesse Lasky, and Harold Lloyd. I testified in Wilmington in another tax case for the American Bemberg Corporation and in Pittsburgh for the National Electric Products Corporation and out in South Bend, Indiana, for the C. G. Conn Band Instrument Company. There are some more but I don't recall them off hand.

Q. Well, I think that's enough, Mr. Muloz. That's a pretty good list. Have you examined the books of the partnership Arthur Murray Dance Studios which are here involved?

A. Yes, I have.

[Vol. 197] Q. Have you read the Stipulation of Facts and the exhibits attached thereto?

A. Yes.

Q. And the other exhibits which have been introduced?

A. Yes.

Q. Have you been in the courtroom and heard the testimony given so far in this case?

A. Yes.

Q. What other information would you need in order to form an opinion as to whether the books and records of the partnership Arthur Murray Dance Studios are maintained under generally accepted and sound accounting principles?

A. None other.

Q. Now, in your opinion are the books and records of the partnership maintained in accordance with generally accepted and sound accounting principles?

A. Yes.

Q. Now, specifically with reference to the item on the books known as deferred income, has this item been handled in accordance with generally accepted and sound accounting principles?

A. Yes, it has.

Q. Why do you say that this item known as deferred income has been handled in accordance with generally accepted and sound accounting principles?

A. Well, it's important to recognize at the outset what it represents. It's the amount of lessons that have been contracted for but have been untaught at the end of the fiscal period. It represents what I consider merely a commitment or agreement on the part of the student to go through with his contract and to take those lessons at some future date. It has nothing to do with lessons that have already been taught. It has only to do with lessons yet to be taught. It's in a sense a backlog that these studios have for lessons to be taught in the future. The deferred income is represented by cash, that is cash advanced payments on an executory contract to the extent that cash has been received, that there has been a deposit or it's backed up by receivables, merely memoranda receivables and in some cases there may have been a note which was discounted at the Bank. To the extent that it's offset, in fact it's entirely offset by either cash or memoranda receivables, the receivables as this business was conducted apparently were not enforceable. There were very large cancellations. Cancellations amounted to in excess, over this five-year period, to 20 percent of the total sales. Now, that ratio would be much higher as to accounts receivable (fol. 198) or these memoranda receivables. I made a test over the five-year period and I found that the cancellations ran as high, they were equivalent to 67 percent of the accounts receivable or all receivables that were outstanding, and that statement applies to the beginning of each of these five fiscal years.

It is important to note, too, that there is no element of profit in this deferred income, this so-called deferred income. This is a liability reserve and while it's taken into account at the contract price of the sale, actually there is no element of profit in it because these Studios were teach-



ing at cost, they were teaching at cost and charging the students simply what it cost them to render the tuition service. Their entire profit was limited to the income that was derived from cancellations and from transfers and a net interest earning, and small capital gains but the entire income of this enterprise throughout the five fiscal years is limited to just those elements. In other words, there was no operating profit at all in this business. In these years in question, at any rate, that is true.

Now, therefore, the entire balance in this deferred income account was simply a liability reserve. It would cost that much to render the service in a future fiscal period. Under those circumstances it was a proper accounting procedure to not take into account this deferred income into the profit-and-loss account until such time as the income was earned, that is when the teaching service was rendered and it would have been highly improper under an accrual method of accounting to take into account income without taking into account matching expenses. The proper accounting under accrual basis is to see that your expenses match your income and the expenses incurred by the teaching were to be rendered in a future fiscal period as far as all this deferred income was concerned. By the employment of this method used by this enterprise, income did not get, that is there was nothing taken into account in earned income until the service was rendered.

Q. You have referred to the memorandum accounts receivables, would you explain that as distinguished from a true account receivable?

A. Yes. A memorandum account receivable would be one that would be set up on the books in connection with [fol. 129] an executory contract, that is where something is to be done in the future when some product is to be shipped or supplied or a service is to be rendered in the future and it is set up, if it is ever set up in the books it is set up only for memorandum purposes and for the purpose of control. That would happen to be necessary in this particular situation. I think I could illustrate it best by taking the example that His Honor used this morning in connection with the sale of an automobile. (A man can go into

an automobile agency and buy a car. When the car was delivered to him then you have a real accounts receivable, but if a man was to go into an automobile agency today and decide he wanted a 1959 model whenever he can get it, and perhaps that car has not been ever manufactured yet but he is going to get that at some future date and he leaves an order for it, that is certainly a memorandum account receivable.

Q. That would be true even though he put a deposit on it?

A. That's right.

Q. Does the accounting method employed by the partnership Arthur Murray Dance Studio actually reflect its true income?

A. It does.

Mr. McCormick: In your opinion?

By Mr. Bauersfeld:

Q. In your opinion?

A. Yes.

Q. Does the system of accounting employed by the partnership bear a true relation to the services rendered and the costs to be incurred by the partnership?

A. It does.

Q. Does the adjustment made to deferred income by the Commissioner in the notices of deficiency in your opinion result in a determination of true income of the partnership?

A. No, it doesn't and on the contrary it results in a material distortion of income.

Q. Will you explain why it results, in your opinion, in a distortion of income?

A. As I said a moment ago, this deferred income was a liability reserve. It will cost this enterprise that full amount to render that service in the future. It has an obligation, a commitment, to give those lessons, and it must spend as much to render the service, render the tuition service, as it has set up in this deferred income account, and it would be highly improper not to match [fol. 200] that cost with that income. In my opinion the income isn't earned, it isn't realized until that service is ren-

dered and there is no matching of the income and the related expenses and you must have that to have a proper and a true and an accurate determination of income under the accrual basis.

Q. Do you know of any other accounting method that would truly reflect the partnership's income?

A. No, I don't, and I think that the system here used was ideally adapted to the necessities of this business and that it conformed with the customs of conducting this business. I think it was ideal in every respect.

Q. Do the tax returns of the partnership, which are in evidence, in your opinion properly or truly reflect its true income?

A. Yes, the tax returns are in conformity with the books. They have been, the books have been consistently maintained on this accounting basis ever since the organization of the enterprise back in 1946. There has been a consistent application of the accounting principles and the tax returns do follow the books.

Mr. Bauersfeld: You may inquire.

The Court: We'll recess now for 10 minutes.

(Recess.)

The Court: We will now proceed.

Mr. Bauersfeld: If the Court please, I have one or two more questions of Mr. Miller.

The Court: Yes. All right.

By Mr. Bauersfeld:

Q. What were the restrictions as to the use of the assets and the deferred-income account?

A. Well, there were several. First of all there was this escrow account that was maintained with Arthur Murray, Inc., the licensor, and pursuant to the license agreement which required this concern to remit to it five percent of its tuition when received. Then there was a restriction also in connection with the so-called reserve account maintained with the Bank where students' notes were discounted with recourse. I think, too, that there is an inherent restriction as to use to a substantial extent in connection with the

[Feb. 201], memorandum accounts receivable, in this respect that you are certainly restricted as to something you are not getting, you will never get it, and the experience of this enterprise has shown that 50 percent of the accounts receivable, the memorandum accounts receivable on the books, at any one time will never be realized. As I said before, the cancellations of receivables have averaged 62 percent of the receivables that were outstanding at the beginning of each of these five years.

Mr. Bauersfeld: You may inquire.

The Court: Cross-examine.

Cross examination.

By Mr. McCormick:

Q. As I understand your testimony, Mr. Miller, it is to the effect that the books and records of this partnership reflect their proper income according to good commercial and theoretical accounting principles.

A. In accordance with sound accounting principles, that is with generally accepted accounting practice, yes.

Q. You do realize there are many differences in commercial accounting and tax accounting do you not?

A. There are some.

Mr. McCormick: I believe that's all.

Redirect examination.

By Mr. Bauersfeld:

Q. In the phrasing of one of the questions on cross-examination, the phrase used was that in "commercial and theoretical principles". Did you mean to imply any of this was theoretical, Mr. Miller?

A. No, I think it's quite the contrary. I think it's very practical. It recognizes the necessities of this particular type of business and my answer was to the effect it's in accordance with sound accounting practices and generally recognized accounting practices.

Q: And there are no artificial or allocations or estimates made in the method that is being used?

A: No.

Mr. Bauersfeld: No further questions.

[fol. 202]

Recross examination.

By Mr. McCormick:

Q. Your testimony with respect to your opinion as to the accuracy of the returns in this case was based upon your conclusion that the books properly reflected the income according to accounting methods, is that not correct?

A. Not entirely, no.

Q. Would you explain that, please?

A. Well, I have yet to see anything in the income-tax statute that says that this isn't a proper accounting method and that by the application of this accounting method you can't arrive at a true income and an accurate income, an accurate income in accordance with the income-tax statutes.

Q. Are you familiar with the many cases in the Supreme Court dealing with the claim-of-right doctrine?

A. Yes, I am.

Q. Aren't those cases dealing with the income-tax statutes?

A. I think—Let me preface this remark by saying right off the bat that I'm not a lawyer but I don't think some of them are but there's a distinction here, too, when you have a memorandum accounts receivable I don't think you have an enforceable right to anything.

Mr. McCormick: I believe that's all.

The Court: All right, Mr. Miller. Thank you.

(Witness excused.)

#### COLLOQUY BETWEEN COURT AND COUNSEL

Mr. Bauersfeld: Petitioner rests.

The Court: Does the respondent have any testimony?

Mr. McCormick: No, sir.

The Court: I suppose the income tax returns and so on are attached to the Stipulation?

Mr. Bauersfeld: Yes, Your Honor.

The Court: All right, gentlemen, what length of time would you like to have in which to file your simultaneous briefs in this case?

[fol. 203] Mr. Bauersfeld: Well, sir, I've tried a whole series of cases this spring. I was wondering if Your Honor would entertain 90 days?

The Court: Well, I think so. I think the Court will have plenty, he has already heard enough to keep him busy. Do you want 90 days, also, Mr. McCormick?

Mr. McCormick: Yes, sir.

The Court: All right, the Court will grant the parties until June 23, 1958, in which to file your opening briefs. I suppose you would want 30 days in which to file reply briefs?

Mr. Bauersfeld: Yes, sir.

Mr. McCormick: Yes, sir.

The Court: You may have that, until July 23, 1958, in which to file your reply briefs.

Mr. Bauersfeld: Thank you, Your Honor.

The Court: I think that concludes all that we have set for today and we'll recess now until 9:30 tomorrow morning.

(Whereupon, at 4 p. m., Monday, March 24, 1958, the hearing was closed.)



## IN THE TAX COURT OF THE UNITED STATES

32 T. C. No. 124

Docket Nos. 62109, 69591, 69592, 69593

MARK E. SCHLUDE and MARZALIE SCHLUDE et al., Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

FINDINGS OF FACT AND OPINION IN DOCKET NOS. 62109, 69591,  
69592 AND 69593—Filed September 28, 1959

The Studio, a partnership operating Arthur Murray Dance Studio, entered into contracts with students whereby [fol. 204] it agreed to furnish dancing lessons and the student agreed to pay therefor. The student would make a down payment and pay the balance in installments, sometimes giving a note therefor. The Studio, an accrual basis partnership, returned as gross income the pro rata amount of the contract price based on the number of lessons taught during the year. Usually, by the end of the year, the balance of the contract price or some portion thereof had been paid by the student. The Commissioner determined that the entire contract price had to be returned as gross income in the year the contract was entered into on the ground that it had been received or accrued. *Held*, for the Commissioner. The entire contract price accrued at the time the contract was entered into since the Studio had a right to receive a fixed and determinable amount.

Carl F. Bannersfeld, Esq., and Einar Viren, Esq., for the petitioners.

William E. McCormick, Esq., for the respondent.

The following proceedings are consolidated herewith: Mark E. Schlude, Docket No. 69591; Marzalie Schlude, Docket No. 69592; and Mark E. Schlude and Marzalie Schlude, Docket No. 69593.

The respondent determined deficiencies in income tax as follows:

Docket No.	Petitioner	Year	Deficiency
62109	Mark E. Schlude and Marzalie Schlude	1950	\$15,819.44
69591	Mark E. Schlude	1952	9,264.69
69592	Marzalie Schlude	1952	8,971.55
69593	Mark E. Schlude and Marzalie Schlude	1953	83,395.82
		1954	11,544.32

Respondent on brief concedes that the proceeding for 1950 (Docket No. 62109) is barred by the statute of limitations. Therefore, findings of fact as to the partnership fiscal year 1950 will in the main be omitted. No deficiency for the fiscal year 1951 was determined.

In the remaining proceedings the deficiencies are based on a number of adjustments, only one of which (for each year) is in issue. The adjustment in issue relates to the income of a partnership known as Arthur Murray Dance Studio in which the petitioners were equal partners. This [fol. 265] adjustment was the adding to the income of the partnership the yearly increases in an account entitled "Deferred Income" on the ground that such amounts represented taxable income.

For the fiscal year 1950, the respondent, in his deficiency notice, explained this adjustment as follows:

#### Explanation of Partnership Adjustments

1.—Income is increased by the amount of prepaid income received during the fiscal year. Income is also increased by the amount of the accounts receivable and notes receivable that are attributable to the fiscal year.

The prepaid income was unrestricted as to use. It clearly represented income to the partnership in the year it is received.

As for the accounts and notes receivable, these are income to an accrual basis taxpayer for the period in which they arise.

All the similar adjustments for the taxable years, in this respect, are the same as above except as to amounts.

### FINDINGS OF FACT

Some of the facts have been stipulated; they are incorporated herein by this reference.

Petitioners Mark E. and Marzalie Schlude, husband and wife, are residents of Omaha, Nebraska, and filed their returns on the cash basis for the years involved with the now director of internal revenue for the district of Nebraska.

On June 18, 1946, the petitioners formed a partnership known as Arthur Murray Dance Studio, hereinafter sometimes referred to as the Studio, in which they were equal partners, for the purpose of conducting dance studios in territories authorized by various franchise agreements received from Arthur Murray, Inc., New York, New York.

The franchise agreements required the partnership to pay Arthur Murray, Inc., a royalty of 10 per cent of the gross receipts of such dancing school or schools. In addition, the agreements required the partnership to pay Arthur Murray, Inc., 5 per cent of its gross receipts to be held in escrow by Arthur Murray, Inc., and to protect and indemnify Arthur Murray, Inc., from any and all claims that may be made against it as a result of granting the franchise to the partnership. The payments to the escrow fund were to continue until the partnership had deposited the total sum of \$20,000 with Arthur Murray, Inc. Thereafter, no further payments were to be made to the fund unless the fund was depleted by payments therefrom, in which case, payments were to be continued or resumed until the fund amounted to the sum of \$20,000. These amounts were required to be paid weekly. The franchise agreement gave Arthur Murray, Inc., control and supervisory powers over many phases of the conduct of the business of the Studio. It also required the Studio to honor the unused portion of paid courses of lessons of students enrolled in any other studio licensed by Arthur

Murray, Inc., by giving lessons to such students. Arthur Murray, Inc., also required other studios to do the same. The sum of \$1.50 per hour was to be paid by the studio holding the contract to the studio giving the lesson.

Pursuant to the franchise agreements, the partnership operated studios for the teaching of private ballroom dancing to individual students. The location of the various studios being operated by the partnership and the date of their formation is as follows:

Location	Date of Formation
Omaha, Nebraska	June 18, 1946
Lincoln, Nebraska	September 20, 1948
Sioux City, Iowa	October 1, 1949
Sioux Falls, South Dakota	June 1, 1952
Grand Island, Nebraska	October 3, 1953

When a student engaged the Studio to teach dancing lessons, the student and the Studio executed one of the six forms of written contracts entitled as follows:

(a) Enrollment Agreement and Contract With Student for Instruction.

[fol. 207] (b) Extension Agreement and Contract With Student for Instruction.

(c) Renewal Agreement and Contract With Student for Instruction.

(d) Deferred Payment Enrollment Agreement and Contract With Student for Instruction.

(e) Deferred Payment Extension Agreement and Contract With Student for Instruction.

(f) Deferred Payment Renewal Agreement and Contract With Student for Instruction.

There are basically two types of contracts entered into between the partnership and students, i. e., the cash plan contracts (contracts (a), (b), and (c)), and the deferred payment plan contracts (contracts (d), (e), and (f)). Each plan has three categories. The first sale of a dance course

represents an original sales contract (contracts (a) and (d)). After the student has contracted for an original course, he has the privilege prior to the fifth hour of instruction on the original course of enlarging that course at a lesser rate by entering into an "extension" agreement course (contracts (b) and (e)). A renewal course (contracts (c) and (f)) is one sold to a student after his completion of the original and extension courses.

Under contracts (a), (b), and (c) a portion of the contract price was paid in cash at the time of signing the agreement and the balance was to be paid in deferred installments. Under contracts (d), (e), and (f) a portion of the down payment was paid in cash at the time of contracting. The balance of the down payment was to be paid in installments and the remaining balance of the contract price was to be paid in the manner set forth in a negotiable note which accompanied the contract.

All of the contracts provided that (1) the student should pay tuition for lessons in a certain amount, (2) the student should not be relieved of his obligation to pay the tuition agreed upon in the contract, (3) no refunds would be made, and (4) the contract is noncancellable. The contracts provided for a specific number of hours of lessons ranging [fol. 208] from 5 hours to 1,000 and 1,200 hours. Some of the contracts were for lifetime courses which, in addition to 1,200 specified hours, the student is entitled to 2 hours of lessons per month plus 2 parties a year for life. Under many of the contracts the lessons extended beyond the fiscal year in which the contract was entered into. Most of the lessons which extended beyond the fiscal year in which the contract was entered into were taught in the fiscal year immediately succeeding the year in which the contract was entered into. At the time of contracting, the student and the Studio did not agree upon a schedule for performance of the lessons upon fixed dates. The dates for instruction were arranged from time to time as lessons were given.

Notes accompanying deferred payment contracts received by the Studio were negotiated with a local bank. At the time a student's note was negotiated with the bank, the

bank would deduct its interest charges and give approximately 50 per cent of the balance of the note to the partnership and set up a reserve account for the other 50 per cent of the note which the partnership could not use until after the note was paid in full by the student. After the note was paid, the balance in the reserve account was transferred to the partnership's general bank account. The notes were transferred to the bank because it was felt that the student (maker of the note) would be more likely to pay the bank than the partnership. The bank made no credit investigation of the student because it had complete recourse against the partnership.

Cash payments received by the partnership directly from students, the amounts received by the partnership at the time notes were transferred to the bank, and the amounts received by the partnership when notes transferred to the bank were fully paid were either deposited or credited to a partnership general bank account without segregation from other partnership funds.

Although the contract stated that they were noncancelable, the Studio frequently rewrote contracts reducing the number of lessons for a smaller sum of money. Also, despite the fact that the contract provided that no refund will be made, and despite the fact that the Studio dis- [fol. 209] couraged refunds, occasionally a refund would be made on a canceled contract.

The Studio paid Arthur Murray, Inc., of New York in weekly payments on Friday of each week, 10 per cent of the gross cash receipts of the Studio for the preceding calendar week. Commissions for selling lessons were, in general, paid at the time cash payments were received by the Studio.

When the partnership was organized in 1946, a public accountant employed by a firm of certified public accountants installed a complete double entry bookkeeping system. An accrual method and a fiscal year ending March 31 were employed. This accounting system was used continually and consistently from 1946 throughout the years in question. The public accountant (who became a certified



public accountant in 1948) installed the accounting system, kept the Studio's books and prepared its partnership income tax returns in conformity with the books.

In addition to the books, individual student record cards were maintained. On these cards are recorded the name and address of the student, the type of contract, the hours involved, the total contract price, and a history of the lessons taught and payments made under the contract.

Under its system of accounting all of the transactions affecting each contract were recorded on individual record cards at the time they occurred. On its books the various transactions were recorded as follows:

(1) When a contract was entered into: *Accounts Receivable* is charged for the total contract price and *Deferred Income* is credited for a like amount.

(2) When a cash payment, down payment or otherwise, on a contract is received: *Cash* is debited and *Accounts Receivable* is credited.

(3) The record does not show the entries which are made when the installment notes are transferred to the bank but it appears that the Studio treated the amounts withheld by the bank, viz., the Reserve Fund, as an Account Receivable.

[fol. 210] (4) Expenses were recorded and deducted in the periods incurred except that the 10 per cent royalties to Arthur Murray, Inc., and certain other items were recorded and deducted when paid. (Actually many of these amounts were also incurred at about the same time as when paid.)

(5) At the close of each fiscal year all of the individual student's record cards were analyzed and the total number of hours taught and remaining untaught were determined. The total number of taught hours was multiplied by the designated rate per hour of each contract. (This rate is apparently arrived at by dividing the total number of contract hours into the total contract price.) The amounts arrived at (taught hours times rate per hour)

for each contract are totaled and this total is regarded as earned income. This amount is then charged to *Deferred Income* and credited to *Earned Income*.

(6) If there had been no activity in a course under a contract for a period of over a year entries would be made canceling the course and contract. In the event a course was canceled or reduced in amount, the following entries would be made: *Deferred Income* would be charged with the amount of deferred income applicable to the canceled portion. (Untaught hours canceled times rate per hour equals amount of deferred income applicable.) *Accounts Receivable* would be credited for the amount due on the canceled hours, if any, and any other amount due which would not be paid because of the cancellation or reduction. The difference between the amount charged to *Deferred Income* and the amount credited to *Accounts Receivable* would be debited or credited to *Gain or Loss on Cancellations*. (There would be a gain if the amount charged to *Deferred Income* exceeded the amount credited to *Accounts Receivable* and a loss if the latter exceeded the former.)

The following schedule reflects the number of untaught hours (of lessons) at the end of the following fiscal years:

[fol. 211]

	March 31, 1952	March 31, 1953	March 31, 1954
Balance—Beginning	15,091½	17,486	31,168
Additions			
Sales	28,975	52,649½	54,128
Deductions	44,066½	70,135½	85,296
Hours taught—transferred to earned income	17,436½	28,436½	39,159
Hours untaught—canceled due to inactivity	9,144	10,531	14,459½
Total deductions	26,580½	38,967½	53,618½
Balance—ending—of untaught hours	17,486	31,168	31,677½

The following schedule reflects a history of the *Deferred Income* account for the fiscal years ended March 31, 1952, 1953 and 1954:

	March 31, 1952	March 31, 1953	March 31, 1954
Contract Amount of Deferred Inc:			
Balance—beginning	\$106,541.70	\$131,143.92	\$235,942.33
Additions during Year Contract amount of sales	235,396.68	430,293.65	452,640.70
Deductions	\$341,938.38	\$561,437.57	\$687,983.03
Contract amount transferred to earned income	\$143,949.63	\$243,277.46	\$325,266.97
Contract amount unearned and canceled due to lack of ac- tivity	66,844.83	82,217.78	113,975.76
Total deductions	\$210,794.46	\$325,495.24	\$439,242.73
Balance—ending—of contract			
Amount of deferred income	\$131,143.92	\$235,942.33	\$248,740.30

The following schedule reflects the beginning and ending balance in the *Deferred Income* account (as shown above) and the net change therein for the following fiscal years:

	March 31, 1952	March 31, 1953	March 31, 1954
Contract Amount of Deferred In- come			
Ending Balance	\$131,143.92	\$235,942.33	\$248,740.30
Beginning Balance	106,541.70	131,143.92	235,942.33
Increase	\$ 24,602.22	\$104,798.41	\$ 12,797.97

[fol. 212] The following schedule reflects the composition of the beginning balance, ending balance, and the net change of the *Deferred Income* account for the following fiscal years:

	March 31 1952	March 31 1953	March 31 1954
<b>Students Accounts Receivable</b>			
(Installment Contracts Carried by Studio Notes Not Yet Processed Through the Bank and Unpaid Balances on Planned Cash Courses)			
Ending Balance	\$ 63,627.23	\$ 86,698.33	\$ 85,177.10
Beginning Balance	55,241.99	63,627.23	86,698.33
Increase or Decrease	\$ 8,385.24	\$ 23,071.10	\$ (1,521.23)
<b>Reserve Fund Held by Bank on Students Notes Financed</b>			
Ending Balance	\$ 7,943.74	\$ 37,747.61	\$ 34,533.22
Beginning Balance	8,112.28	7,943.74	37,747.61
Increase or Decrease	\$ (168.54)	\$ 29,803.87	\$ (3,214.39)
<b>Deferred Income Collected</b>			
(Considering Reserve Fund Held by Bank as Not Collected Until Funds Are Released and Made Available for Withdrawal by Bank)			
Ending Balance	\$ 59,572.95	\$ 111,496.39	\$ 129,029.98
Beginning Balance	42,187.43	59,572.95	111,496.39
Increase	\$ 16,385.52	\$ 51,923.44	\$ 17,533.59

Unpaid balances on notes held by the bank for the fiscal years ended March 31, 1952, through March 31, 1954, were as follows:

	March 31 1952	March 31 1953	March 31 1954
Ending Balance	\$ 9,618.00	\$ 40,627.96	\$ 23,440.75
Beginning Balance	1,842.10	9,618.00	40,627.96

\* By composition we mean the debits corresponding to the credits in the *Deferred Income* account. For example, the balance in the *Deferred Income* account at March 31, 1952, is \$131,143.92. This amount is represented by the following ended balances at March 31, 1952:

<b>Uncollected—</b>		
Student Account Receivable		\$ 63,627.23
Reserve Fund—Bank		7,943.74
Collected		59,572.95
		<b>\$131,143.92</b>

In order to check the composition of any of the balances or net changes in the *Deferred Income* schedule the same computation must be made

[fol. 213] The following schedule reflects the amount of sales canceled, the uncollectible accounts receivable on the canceled sales, and the gain on cancellations on the Studio's books and returns for the years involved:

	Fiscal Years Ended March 31		
	1952	1953	1954
Sales Canceled	\$ 66,844.87	\$ 82,217.78	\$113,975.71
Uncollectible Receivable on Cancellation	39,983.43	62,734.42	85,527.15
Gain on Cancellation	\$ 26,861.40	\$ 19,483.36	\$ 28,448.61

The following schedule reflects ordinary gross income and deductions on the Studio's books and returns for the following fiscal years:

	March 31 1952	March 31 1953	March 31 1954
Gross Income			
Contract Amts. transferred			
Earned Income	\$143,949.63	\$243,277.46	\$325,266.91
Gains from cancellation	26,861.40	19,483.36	28,448.61
Other Income	4,041.21	11,426.23	16,987.31
Total	\$174,852.24	\$274,187.05	\$370,702.83
Deductions	137,267.91	223,390.69	301,609.76
Ordinary Net Income	\$ 37,584.33	\$ 50,796.36	\$ 69,093.07

The respondent, in his notices of deficiency, increased the ordinary net income of the partnership for the fiscal years ended March 31, 1952, 1953, and 1954, by the amounts of the increases in the *Deferred Income* account in those years, viz., \$24,602.22 for 1952, \$104,798.41 for 1953, and \$12,797.97 for 1954. (See schedule of income in *Deferred Income* account, supra.)

A supplemental stipulation of facts was filed, April 8, 1958, which reads as follows:

It is hereby stipulated that the tuition paid to other studios during the taxable years ending March 31, 1950 to March 31, 1954, inclusive, is as follows:

3. The respondent also disallowed certain expenses of the Studio, which are not in issue, and added to each partner's distributive share of partnership income his respective share of the additional income

[fol. 214]

Taxable year ended March 31, 1950	\$ 592.00
Taxable year ended March 31, 1951	751.10
Taxable year ended March 31, 1952	825.00
Taxable year ended March 31, 1953	1,328.13
Taxable year ended March 31, 1954	1,955.32

### OPINION

Black, Judge: The petitioners are equal partners in the Studio, a partnership which owns and operates five Arthur Murray Dance Studios under franchise agreements with Arthur Murray, Inc. In dispute is the amount of the Studio's gross income. Specifically, the dispute relates to the manner in which the receipts from contracts for dancing lessons are to be reported.

The problem may best be explained by the following illustration: On August 1, 1952, the Studio enters into a contract with a student whereby the Studio agrees to teach the student 24 1-hour dancing lessons and the student agrees to pay \$240 therefor, \$100 down and \$20 per month for the next 7 months. (In some cases the student gives a negotiable note for the installment payments.) Lessons are arranged from time to time and at the end of 1952 the Studio has given the student 10 lessons and the student has paid \$180, the \$100 down and four \$20 installments. By March, 1953, the Studio gives the student 10 additional lessons and the student pays \$40, two more installments. The student loses interest in the course and does not take the remaining four lessons and the Studio is unable to collect the remaining \$20.

In 1952 the Studio, which reports on an accrual basis, returns as gross income \$100, representing 10 lessons taught at \$10 per lesson. During 1953 the Studio returns as gross income \$100 representing 10 lessons taught at \$10 per lesson. After the contract has been inactive for a year the Studio cancels it, computing a gain or loss thereon. Here the gain would be \$20. (Four lessons untaught at \$10 per lesson equals \$40, less contract price unpaid of \$20 equals \$20 gain.) This \$20 gain on cancellation would be returned as gross income in 1954.



[fol. 215] The Commissioner determined that the entire \$240, the contract price, should be returned in 1952 when the contract was entered into and the amount of the contract was paid or agreed to be paid. We agree.

The Studio, being on an accrual basis, must return items of gross income in the year in which they accrued. Section 42, "Items must be accrued as income when the event occurs to fix the amount due and determine liability to pay." *Spring City Foundry Co. v. Commissioner*, 292 U. S. 182 (1934). When the contracts were entered into the amounts due thereunder were fixed and the students were "liable to pay." It is true that a payment of a portion of the contract price was deferred but that does not affect the fixed and unconditional right of the Studio to receive the amount. Nor does the fact that the Studio was required to perform future services under the contract alter the Studio's right to receive since the deferred payments were in many cases due prior to the rendering of the services. And the record shows that in most instances substantial payments were received prior to the performance of the services for which the payments were made.

The exception to the rule stated above is where there is a real uncertainty as to whether the taxpayer will ever receive the amount in question, cf. *San Francisco Stevedoring Co.*, 8 T. C. 222. Here the Studio actually received substantial cash or negotiable notes under each contract. The contracts themselves provided that they were non-cancellable and that no refunds should be made. Despite this provision in the contract some contracts were canceled. The facts show that the cancellations were considerable in amount. These amounts, according to the Studio's records, were about 17 per cent, 15 per cent, and 19 per cent of sales for the respective years. Assuming that the rate of cancellation was about 17 per cent of sales that fact still would not provide a sufficient basis for a finding that there was a real uncertainty that the amounts due under any one or all of the contracts would be uncollectible (and therefore not accruable) at the time the contract(s) were entered into. The normal manner of providing for this type of contingency is through the use of a bad debt reserve. We

have no issue in the instant case as to any addition to a [fol. 216] bad debt reserve nor do we have any issue concerning debts of the partnership which became worthless in the taxable year.

It seems to us that the instant case is controlled by our decision in *Curtis R. Andrews*, 23 T. C. 1026, on the first point decided in that case. That first point decided in the *Andrews* case was essentially the same as the main issue we have in the instant case. While it is true that the facts in the *Andrews* case are not precisely the same as the facts in the instant case, nevertheless we do not think that such differences in facts as do exist would justify a holding in the instant case different from what we held in the *Andrews* case. For example, in the *Andrews* case, according to the Findings of Fact, the Arthur Murray Studios in that case did not have any accounts receivable but they did take notes receivable from their dancing students. In the instant case, apparently the Studio had accounts receivable as well as notes receivable. This difference, it seems to us, is not sufficient to make a valid distinction between the *Andrews* case and the instant case. To an accrual taxpayer, accounts receivable must be taken into income just the same as notes receivable. We know of no authority to the contrary. Petitioners, in their brief, argue that their accounts receivable for dancing lessons contracts were not true accounts receivable but were what they term "memorandum accounts receivable." Their argument on this point is, in part, stated in their brief as follows:

The record shows that at the time the contract is executed and the entries made to the deferred income account, the so called students accounts receivable at that time are not true, earned receivables. True accounts receivable are entered after a product has been delivered or services have been rendered.

In other cases before our Court we have not made the distinction in accounts receivable which petitioners seek to draw. See *Your Health Club, Inc.*, 4 T. C. 385, which we will discuss more at length later.

Another difference in the facts in the *Andrews* case from those present in the instant case is that in the *Andrews* case when the Arthur Murray Studio partnership transferred the notes which it took from its students to the bank, the bank paid the studio partnership the full face amount of the notes, less a six per cent discount. In the instant case, when the Studio partnership transferred the student notes to the bank, it did not receive from the bank the full face amount of the notes. The bank held back 50 per cent of the face amount of the notes and set up a reserve account of the amounts withheld which the partnership could not use until after the note was paid in full by the student. This fact, however, does not preclude the accrual as income of the full amount of the note when it is received from the student. Cf. *Commissioner v. Hansen et al.*, U. S. , decided June 22, 1959. These were the so-called "Dealers' Reserve Accounts" cases. In the *Hansen et al.* cases the Supreme Court held that the transactions involved were sales of installment paper and the amount of the purchase price retained and recorded as a liability to each dealer accrued as income to him, even though he could not presently recover it, since he had a fixed right to such sum whether it was applied, as he had authorized, to payment of his obligation as guarantor or endorser of the installment paper, or paid to him in cash.

One of the cases relied upon by us in *Curtis R. Andrews, supra*, was *Your Health Club, Inc., supra*. In the latter case the taxpayer corporation was engaged in the business of operating a health club. Its activities consisted in furnishing facilities and services for various sport activities, Russian and Turkish baths, massages, ultra violet ray and solarium treatments. These services and facilities were furnished by the taxpayer under contracts entered into with members. The contract membership entitled members to avail themselves of taxpayer's facilities for a period of 1 year; once, twice, or three times a week according to the type of contract selected by the member. The taxpayer kept its books and filed its returns on an accrual basis. All contracts entered into were immediately entered upon the books of the taxpayer in full. At the end of the taxable year, in the case of contracts extending beyond the close of

the year, the membership fee was allocated in each instance between the expired and unexpired portion of the contract, such allocation being based upon the number of months yet to run under the contract. The amounts allocated to the [fol. 218] expired portion of the contracts were carried to gross income for that year and the balance was set up in the form of a "reserve for uncompleted contracts" and excluded from the gross income of the taxable year as "unearned income." Generally, the members paid their membership fees in advance in cash, but not always. For example, during the fiscal year ended March 31, 1940, membership contracts entered into amounted to \$48,280.21. Of this amount, \$42,800.85 was paid in cash during the year and the balance represented accounts receivable due at the close of the year. The taxpayer filed its income tax returns in accordance with its method of allocation above described. The Commissioner disallowed this method as not correctly reflecting income and determined deficiencies. We upheld the Commissioner. In doing so we said:

The amounts paid in cash were deposited in petitioner's general account and were subject to no restrictions as to use or application. The amounts unpaid but accrued constituted accounts receivable as of the close of the taxable year, and were unqualifiedly due and payable. In these circumstances, all such amounts received or accrued must be considered income to petitioner in the year received or accrued. (Citing numerous cases not necessary to enumerate here.)

Thus, it will be seen from the foregoing recitals from the *Your Health Club, Inc.*, case that the services which the taxpayer corporation in that case contracted to render its members, some of which lapsd over into the following year, were Russian and Turkish baths, massages, ultra-violet ray treatments, etc. The taxpayer sought, by its method of accounting, to give recognition to this lapse over of services to be rendered into the following year by allocating part of the membership fees provided for in the contract to the following year. This we denied in the *Your Health Club, Inc.*, case for reasons already stated.

While it is, of course, true that the giving of Turkish and Russian baths and massages is somewhat different from giving dancing lessons, we think there is no difference in principle as to how the contract price for the two kinds of services should be treated from an accounting [fol. 249] standpoint by one on an accrual basis. The rule which must govern the respective taxpayers, *Your Health Club, Inc.*, and the Studio in the instant case, is as was said in *Your Health Club, Inc.*: "In these circumstances, all such amounts received or accrued must be considered income to petitioner in the year received or accrued."

We think it was quite appropriate for us, in *Carter R. Andrews*, supra, to cite and rely upon the *Your Health Club, Inc.*, case as one of our supporting authorities for the result reached in that case. We also think it is appropriate to do so here. Cf. *Automobile Club of Michigan v. Commissioner*, 353 U. S. 180, affirming 230 F. 2d 585, which affirmed our decision, 20 T. C. 1033. See also *Automobile Club of New York, Inc.*, 32 T. C.

Reviewed by the Court.

Decision will be entered for the petitioners in Docket No. 62109.

Decisions will be entered under Rule 50 in Docket Nos. 69591, 69592, and 69593.

PIERCE, J., dissenting:

1. As to those contracts for future services under which the entire contract price had not been prepaid either by cash or notes, and under which certain payments were not due to be made until a subsequent taxable year, I agree with the views expressed by Judge Train in his dissenting opinion. Such contracts were executory as to both parties, and the obligations to make the future payments thereunder had not matured, so as to become true accounts receivable, at the times when the contracts were executed. In such situation, I think there is no more justification for accruing the future contract payments as income of the year in which the contracts were executed, than there

would be for accruing as income at the time a lease is executed, all rental payments contracted to be made in subsequent years under such lease. The fact that a contract for future services, or a lease for future use of property, may be legally enforceable is not in itself justification for [fol. 220] accruing as income of the year in which the instrument is executed, all payments to be made thereunder in future years.

2. Even as to those contracts for future services upon which prepayment had been made, I think this Court has erred in refusing to permit the taxpayer to spread the income over the periods in which such income was to be earned, in accordance with sound business accounting principles. On the basis of the authorities and reasons which I have heretofore set forth in my dissenting opinion in the case of *Automobile Club of New York, Inc.*, 32 T. C. (filed July 20, 1959), I think that such action of the Court not only defeats a true reflection of income, but also is out of harmony with the weight and trend of Courts of Appeals authority.

TRAIN, Judge: I respectfully dissent.

I do not agree that the petitioners should be required to report as income amounts which were not received in the taxable year, either in cash or by notes, and which were not due and payable by the close of the taxable year.

The majority opinion relies heavily on *Curtis R. Andrews*, 23 T. C. 1026 (1955), which applied the so-called claim of right doctrine and prohibited the deferral of amounts received but not earned in the taxable year. The facts of the instant case disclose that a portion of the contract amounts were not paid either in cash or by notes in the taxable year. As to that portion of the "student accounts receivable", the claim of right doctrine can have no applicability and the majority's reliance on the *Andrews* case is misplaced.

Moreover, even though the student's contractual obligation arose at the time of signing, it is clear that the contract amounts did not become due and payable in their



entirety in that year. To the extent that these same unpaid amounts were not due and payable in the taxable year, I do not believe that *Your Health Club, Inc.*, 4 T. C. 585 (1944), is authority for their inclusion in income of that year.

[fol. 221] I believe that the conclusion reached by the majority does violence to established rules of accounting, whether for business or tax purposes, and results in a distortion of income.

Drennen, J., agrees with this dissent.

# IN THE TAX COURT OF THE UNITED STATES

## ORDER STRIKING AND SUBSTITUTING CERTAIN LANGUAGE IN OPINION—November 23, 1959

At the conclusion of the Opinion filed in these proceedings on September 28, 1959, we directed that the decision in Docket No. 62109 be entered for the petitioners and the decisions in Docket Nos. 69591, 69592, and 69593 be entered under Rule 50.

On November 19, 1959, respondent filed a motion in which he asked that the words "Decisions will be entered under Rule 50 in Docket Nos. 69591, 69592, and 69593" be stricken and that there be substituted for the language stricken the words "Decisions will be entered for the respondent in Docket Nos. 69591, 69592, and 69593." Counsel for petitioners has noted "No Objection" to said motion. Therefore, it is :

Ordered, that said motion is granted and the words "Decisions will be entered under Rule 50 in Docket Nos. 69591, 69592, and 69593" in our Opinion filed September 28, 1959, be stricken and that there be substituted therefor "Decisions will be entered for the respondent in Docket Nos. 69591, 69592, and 69593."

Eugene Black, Judge

Dated: Washington, D. C., November 23, 1959

(Seal)

[fol. 222]

IN THE TAX COURT OF THE UNITED STATES

WASHINGTON

Docket No. 69591

MARK E. SCHULDE, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Decision in Docket No. 69591 November 23, 1959.

Pursuant to the determination of the Court as set forth in its Findings of Fact and Opinion filed September 28, 1959, and Order of this Court dated November 23, 1959, it is:

Ordered and Decided: that there is a deficiency in income tax for the taxable year 1952 in the amount of \$9,264.69.

Eugene Black, Judge

Enter:

Entered Nov. 23, 1959:

(Seal)

IN THE TAX COURT OF THE UNITED STATES

WASHINGTON

Docket No. 69592

MARZACH SCHULDE, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Decision in Docket No. 69592 November 23, 1959.

Pursuant to the determination of the Court as set forth in its Findings of Fact and Opinion filed September 28,

[Vol. 223] 1959, and Order of this Court dated November 23, 1959, it is

Ordered and Decided: that there is a deficiency in income tax for the taxable year 1952 in the amount of \$8,971.55.

Enter:

Eugene Black, Judge

Entered Nov. 23, 1959.

(Seal)

IN THE TAX COURT OF THE UNITED STATES

WASHINGTON

Docket No. 69593.

MARK E. SCHULDE AND MARZALIE SCHULDE, Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Decision in Docket No. 69593 November 23, 1959.

Pursuant to the determination of the Court as set forth in its Findings of Fact and Opinion filed September 28, 1959, and Order of this Court dated November 23, 1959, it is

Ordered and Decided: that there are deficiencies in income tax for the taxable years 1953 and 1954 in the respective amounts of \$83,395.82 and \$11,544.32.

(Signed) Eugene Black, Judge

Enter:

Entered Nov. 23, 1959.

(Seal)

[Vol. 224]

## IN THE TAX COURT OF THE UNITED STATES

The United States Court of Appeals  
For the Eighth Circuit.

T. C. Docket Nos. 69591, 69592, 69593

MARK E. SCHLUDER AND MARZALIE SCHLUDER, Husband and  
Wife, Petitioners on Review.

v.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent on Review.PETITION FOR REVIEW OF DECISIONS IN DOCKET NOS. 69591;  
69592 AND 69593. Filed February 3, 1960.

Petitioners on review are Mark E. Schluder and Marzalie Schluder, husband and wife, whose address is 459 Beverly Drive, Omaha, Nebraska. Petitioners on review filed separate individual income tax returns for the year 1952 and joint returns for the years 1953 and 1954, the taxable years here involved, with the now Director of Internal Revenue for the District of Nebraska at Omaha, Nebraska, which collection district is within the jurisdiction of the United States Court of Appeals for the Eighth Circuit, where this review is sought.

The petitioners on review petition the United States Court of Appeals for the Eighth Circuit to review the decisions entered by the Tax Court of the United States on the 23d day of November, 1959, wherein and whereby it was ordered and decided that there were deficiencies in income tax in respect of the Federal income tax liabilities of the above-named petitioners on review for the years 1952 to 1954, inclusive, as follows:

Petitioner	Docket No.	Year	Deficiency
Mark E. Schluder	69591	1952	\$ 9,264.69
Marzalie Schluder	69592	1952	8,971.55
Mark E. Schluder and		1953	83,395.82
Marzalie Schluder	69593	1954	11,544.32

[fol. 225]. The respondent on review is the duly appointed qualified and acting Commissioner of Internal Revenue, appointed and holding office by virtue of the laws of the United States.

This petition for review is filed pursuant to the provisions of sections 1141 and 1142 of the Internal Revenue Code of 1939 and sections 7482 and 7483 of the Internal Revenue Code of 1954.

### Nature of Controversy.

On June 18, 1946, petitioners on review, Mark E. Schlude and Marzalie Schlude, formed a partnership for the purpose of conducting Arthur Murray Dance Studios in territories authorized by a franchise agreement received from Arthur Murray, Inc., New York City, New York.

From its inception, the partnership employed a certified public accountant to install its bookkeeping system, and that accountant maintained its books since that date. The partnership's books of account have been maintained on a fiscal-year basis ending March 31, and the accrual method of accounting has been employed. The partners report their income on a calendar-year basis.

The partnership is engaged in the business of giving private ballroom dance instruction to students. There are basically two types of contracts with students: (1) a cash plan and (2) a deferred-payment plan. The dance courses given cover a certain number of hours which range from five hours to one-thousand hours or even to lifetime courses. Some of the contracts extend beyond the taxable year in which the contract is made. In many of the deferred-payment contracts payment was not due until after the year of making the contract. The partnership reported the income it received from the dancing business when it was earned. Expenses were taken into account when incurred, regardless of when paid. In other words, the advance payments for dancing instructions were not taken into account until hourly instruction was given. That is the time when the income was earned and the operating costs are known. The partnership returned as

[fol. 226] gross income the pro rata amount of the contract price based on the number of lessons taught during the year.

The Commissioner of Internal Revenue determined that the entire contract price had to be returned as gross income in the year the contract was entered into on the ground that it had been received or accrued. The Tax Court sustained the Commissioner and held that the entire contract price accrued at the time the contract was executed. The question presented for decision is: Has the partnership reported its true income?

#### STATEMENT OF POINTS UPON WHICH PETITIONERS ON REVIEW INTEND TO RELY

The Tax Court of the United States erred:

(1) In holding and deciding that petitioners owed deficiencies in income tax for the years 1952 to 1954, as follows:

Petitioner	Docket No.	Year	Deficiency
Mark E. Schlude	69,591	1952	\$ 9,264.69
Marzalie Schlude	69,592	1952	8,971.55
Mark E. Schlude and		1953	83,395.82
Marzalie Schlude	69,593	1954	11,544.32

(2) In holding and deciding that the entire contract price for dancing lessons accrued at the time the contract was entered into.

(3) In holding and deciding that the partnership, Arthur Murray Dance Studios, was required to take into income the entire amount of a contract price for dancing lessons when the contract was entered into, regardless of when the contract price was paid or agreed to be paid or regardless of when the services were agreed to be rendered.

(4) In holding and deciding that the signing of a contract for dancing lessons was the event which fixed the amount due and determined the student's liability to pay with sufficient certainty as to cause the entire amount to be immediately accruable.



[fol. 227] (5) In holding and deciding that the cancellation of about 17 per cent of sales would not provide a sufficient basis for finding that there was a real uncertainty that the amounts due under any one or all of the contracts would be uncollectible at the time the contracts were entered into.

(6) In holding and deciding that the memorandum accounts receivable of students were true accounts receivable.

(7) In holding and deciding that the partnership must take into income each year the yearly increases in the deferred income account on the books of the partnership.

(8) In failing to hold and decide that the partnership reported its true income and that the method of accounting employed consistently and properly reflects its true income and is the only practical business way of keeping its books and reporting its income.

(9) In failing to hold and decide that the accounting method employed by the partnership reflects the consistent application of generally accepted accounting principles.

(10) In failing to take into consideration and disregard the uncontradicted and unimpeached testimony of the witnesses for petitioners on review, who testified that the books and records of the partnership were maintained in accordance with generally accepted and sound accounting principles which properly reflected the partnership's true income.

(11) In failing to take into consideration and disregard the uncontradicted and unimpeached testimony of the witnesses for petitioners on review, who testified that the method of accounting and of adjustments proposed by the Commissioner would distort the partnership's income.

(12) In that each of the decisions is not supported by the evidence.

(13) In that the decisions are contrary to law.

Wherefore, the taxpayers petition that the opinion and decision of the Tax Court, to which they are referred to, be reversed.

[fol. 228] viewed by the United States Court of Appeals for the Eighth Circuit; that a transcript of record be prepared in accordance with the law and rules of said Court and transmitted to the Clerk of said Court for filing; that appropriate action be taken to the end that errors complained of may be reviewed and corrected by the Federal Court.

Mark E. Schlude, Marzalie Schlude, by Robert Ash,  
1921 Eye Street, N. W., Washington 6, D. C.,  
Attorney for Petitioners on Review.

Of Counsel: Einar Viren, Omaha, Nebraska.

February 3, 1960.

Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 229]

IN THE UNITED STATES COURT OF APPEALS FOR THE  
EIGHTH CIRCUIT

Docket No. 16,443

MARK E. SCHLUDE and MARZALIE SCHLUDE, Husband and  
Wife, Petitioners on Review,

v.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent on Review.

DESIGNATION OF PETITIONER OF PARTS OF RECORD TO BE  
PRINTED ON REVIEW—Filed March 16, 1960

Come now the petitioners on review in the above captioned case and request that the following parts of the record be printed under supervision of the Clerk of the Court:

1. Docket entries of proceedings in Tax Court  
Docket Numbers 69591, 69592 and 69593.

2. Pleadings:

(a) Petition, including annexed copies of notices of deficiency and statement attached, in each of the above Tax Court docketed numbers.

(b) Answers in each of the above named docketed cases.

3. Stipulation of facts, together with Exhibits 1A to 21U, inclusive.

[fol. 230] 4. Supplemental stipulation of facts.

5. Official report of proceedings before the Honorable Eugene Black, Judge of the Tax Court of the United States at Omaha, Nebraska, on March 24, 1958.

6. Petitioners' Exhibits 22 to 31, inclusive.

7. Findings of fact and opinion of the Tax Court of the United States, filed September 28, 1959.

8. Decisions of the Tax Court of the United States entered in each of the above-named docketed cases on November 23, 1959.

9. Petition for review, filed February 3, 1960.

Robert Ash, 1921 Eye Street, N.W., Washington 6, D. C., Attorney for Petitioners on Review.

[fol. 231]

IN THE UNITED STATES COURT OF APPEALS FOR THE  
EIGHTH CIRCUIT.

No. 16,443.

MARK E. SCHLADE and MARZALIE SCHLADE, Husband and  
Wife, Petitioners.

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

On Petition to Review Decision of The Tax Court of the  
United States.

OPINION — December 15, 1961

Before SANBORN, VAN OOSTERHOUT and MATTHEWS, Circuit  
Judges

PER CURIAM.

For the second time this case is here for determination. Our first opinion, 283 F.2d 234, reversed the decision of the Tax Court. On June 19, 1961, the Supreme Court of the United States rendered its decision in *American Automobile Association v. United States*, 367 U.S. 687. On the same day the Supreme Court, by per curiam order in this case, directed that "the judgment is vacated and the case is remanded in light of *American Automobile Association v. United States* . . . ." *Commissioner of Internal Revenue v. Schlade et al.*, 367 U.S. 911. [fol. 232] On October 9, 1961, in denying petition for rehearing, the Supreme Court amended its per curiam order of June 19, 1961, as follows: "The judgment is vacated and the case is remanded for further consideration in the light of

*American Automobile Association v. United States* . . .  
(Emphasis supplied.)

Pursuant to our invitation, counsel for petitioners and the Commissioner filed supplemental briefs and presented oral arguments directed largely to the question of whether this case falls within the ambit of the teachings of *American Automobile Association*, *supra*. In light of that case we have carefully examined and considered petitioners' method of accrual accounting and are convinced that such method does not, for income tax purposes, clearly reflect income.

Accordingly, our judgment previously entered is vacated, and the decision of the Tax Court is affirmed.

[fol. 233]

IN THE UNITED STATES COURT OF APPEALS FOR THE  
EIGHTH CIRCUIT

September Term, 1961.

No. 16,443

MARK E. SCHLUDE and MARZALIE SCHLUDE, Husband and  
Wife, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

JUDGMENT—December 15, 1961

On Petition to Review Decision of The Tax Court of the  
United States,

This cause came on to be heard on the Petition to Review the Decisions of The Tax Court of the United States entered November 23, 1959 (Tax Court Docket Nos. 69591, 69592 and 69593), determining that there are deficiencies in the income taxes of the Petitioners for the years 1952, 1953 and 1954, after remand by the Supreme Court of the United States for further consideration in the light of the

decision in *American Automobile Association v. United States*, 367 U.S. 687, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the Opinion of this Court heretofore filed October 19, 1961, be withdrawn, and the judgments entered thereon is hereby vacated, set aside and held for naught.

It is further Ordered and Adjudged by this Court that the decisions of The Tax Court of the United States be, and they are hereby, affirmed.

And it is further Ordered and Adjudged by this Court that the petition to review in this cause be, and the same is hereby, dismissed.

December 15, 1961.

[fol. 234]

IN THE UNITED STATES COURT OF APPEALS FOR THE  
FOURTH CIRCUIT

September Term, 1961.

No. 16,443

MARK F. SCHULDE and MARZALIE SCHULDE, Husband and  
Wife, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Petition to Review Decision of The Tax Court of the  
United States.

ORDER STAYING ISSUANCE OF MANDATE, ETC.—

December 29, 1961

On Consideration of the Motion of the petitioners for a stay of the mandate in this cause pending a petition to the Supreme Court of the United States for a writ of certiorari.



it is now here Ordered by this Court that the issuance of the mandate herein be, and the same is hereby, stayed for a period of thirty days from and after this date, and, if within said period of thirty days there is filed with the Clerk of this Court a certificate of the Clerk of the Supreme Court of the United States that a petition for writ of certiorari and record have been filed, the stay hereby granted shall continue until the final disposition of the case by the Supreme Court.

December 29, 1961.

[fol. 235]. Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 236]

SUPREME COURT OF THE UNITED STATES

No. 793—October Term, 1961

MARK E. SCHLUDE, et al., Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

ORDER ALLOWING CERTIORARI—May 28, 1962

The petition herein for a writ of certiorari to the United States Court of Appeals for the Eighth Circuit is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Frankfurter took no part in the consideration or decision of this application.

[fol. 237]

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1961

& No. 793

MARK E. SCHLUDE and MARZALLIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for Writ of Certiorari to the United States  
Court of Appeals for the Eighth Circuit

STIPULATION AND ADDITION TO RECORD—Filed June 5, 1962

It is hereby stipulated and agreed by and between counsel for the respective parties to the above-entitled cause that the Clerk of the Supreme Court shall cause to be printed as a part of the record in the case, the Opinion of the United States Court of Appeals for the Eighth Circuit in "Mark E. Schlude, et al., Petitioners, v. Commissioner of Internal Revenue, Respondent No. 16443", dated October 19, 1960. A certified copy of said Opinion is attached hereto [fol. 238] and made a part of this Stipulation by reference.

Archibald Cox, Solicitor General, The Department  
of Justice, Attorney for Respondent,

Robert Ash, 1924 Eye Street, N.W., Washington 4,  
D. C., Attorney for Petitioners.

Dated: June 5, 1962.

[Vol. 239]

ATTACHMENT TO SUBMITTATION  
UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT  
No. 16,443

MARK E. SCHULDE and MARZALIE SCHULDE, Husband and  
Wife, Petitioners.

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Petition to Review Decisions of the Tax Court of the  
United States.

Origination - Filed October 19, 1960

Withdrawn December 15, 1961

Before Sanborn, Woodbridge, and Matthes, Circuit Judges.

Matthes, Circuit Judge.

The Commissioner of Internal Revenue determined that a deficiency existed in the tax liability of petitioners for the years 1952 to 1954, inclusive, as follows:

Mark E. Schulte for 1952	\$ 9,264.00
Marzalie Schulte for 1952	\$ 971.50
Mark E. and Marzalie Schulte for 1953	\$ 3,265.82
Mark E. and Marzalie Schulte for 1954	\$ 11,544.32

fol. 240. The Tax Court, with three Judges dissenting, affirmed the action of the Commissioner. See 32 T.C. 1271. Pursuant to 1141, 1142 of the Internal Revenue Code of 1939 and 7482, 7484 of the 1954 Code, petitioners have brought the case to this Court for review.

The facts, established by stipulation of the parties and evidence, are detailed in the findings of the Tax Court. Those essential to a proper understanding of the question presented for fair deduction and credits to petitioners, husband and wife, on June 18, 1946, to form a partnership known as Arthur Murray Dances, Inc., for the purpose of conducting and operating dance studios authorized by certain franchise agreements entered into with Arthur Murray, Inc., of New York City. The venture was carried into effect and the partnership operated studios in the States of Nebraska, Iowa and South Dakota for the purpose of teaching private ballroom dancing to individual students.

Basically, there were two kinds of contracts entered into between the partnership and students desiring dancing instructions. Under one, a portion of the total tuition was paid in cash when the contract was executed, and the balance of deferred installments. Under the other a portion of the down payment was paid in cash at the time the contract was entered into and the balance of the down payment was to be paid in installments, the remainder of the contract price being evidenced by a promissory note, taken from the student, payable in designated installments in accordance with the terms of the note. Under the contract the student agreed to take a designated number of hours of dancing lessons and pay therefor the amount specified as stated. All types of contracts contained a non-cancelable provision fol. 241 and provided that the student should not be released of his obligation to pay the tuition needed upon the hours of lessons or instructions contracted for (ranging from 5 to 1,000 to 1,300). Some of the contracts were for life contracts, which meant that, once entered into, they could not be terminated or canceled. Others were for a specified number of months plus two parties a year for life. Both types of terms

the studio was required to give the number of hours of instruction agreed upon. The contracts, however, did not schedule the dates when the studio was required to give and the student was to receive instructions, this detail being arranged and agreed upon from time to time as lessons were given. Under many of the contracts, lessons extended beyond the fiscal year in which the contract had its inception.

Notes taken from students were transferred with full recourse, to a local bank, which at the time of acquiring a note, would deduct therefrom the interest charges, and give approximately 50% of the balance of the note to petitioners. Installment payments on the remainder of the note were held by the bank in a reserve account, but this reserve was not available to petitioners until the note was paid in full by the student, after which the reserve was transferred to the partnership's general bank account.

A sizeable number of contracts was cancelled annually, the non-cancellable provision to the contrary notwithstanding. In its opinion, the Tax Court conceded that "cancellations were considered in amount", noting that records of the partnership disclosed that cancellations for the respective years involved were 17%, 15%, and 13% of sales for the respective years.

fol. 242. A complete double entry bookkeeping system was installed for the partnership by a certified public accounting firm at the time that the partnership was organized, and an accrual system of accounting was employed, with the fiscal year ending March 31. This accounting system was used continually and consistently from the time the partnership was formed. Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract.

Since the method pursued by the partnership with respect to its operations under its accrual system of account-

32 T.C. at p. 1279. Petitioners insist that the Tax Court's percentages of cancellations are inaccurate; that sales in the amount of approximately 28.4%, 19.1%, and 25.2% were cancelled in the fiscal years 1952, 1953 and 1954.

ing and the effect thereof from an income tax standpoint are fully and correctly shown in the findings of the Tax Court, we shall forego a repetitious analysis of the manner in which the student transactions were processed insofar as they bear upon the tax question. It is sufficient to say that when a contract was entered into with a student, the "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and determination was made of the number of hours of lessons taught which, multiplied by the rate per hour of each contract, gave the amount of income earned. This amount was then charged to "deferred income" and credited to "earned income." Earned income thus arrived at was reported as income on the partnership's tax return. If there was any gain resulting from cancellation of a contract, this amount was also considered as taxable income and reported as such. Detailed schedules which correctly and precisely reflect the result of the partnership's accrual system of accounting during the years in question appear in the findings of fact of the Tax Court.

[fol. 243] The deficiencies under consideration resulted from the Commissioner increasing the ordinary *net* income of the partnership for the fiscal years ending March 31, 1952, 1953 and 1954, by the amount of the increases in the deferred income account in those years, as follows: \$24,602.22 in 1952, \$104,798.41 in 1953, and \$12,797.97 in 1954. This determination was made and upheld by the Tax Court through application of the "claim of right doctrine," meaning that, for income tax purposes, the full amount of its contract price had to be returned as income in the year in which the contract was entered into, irrespective of any obligation on the part of the partnership to render services under the contract in years subsequent to the year in which the agreement was made.

This case once more brings into sharp focus the question of when income shall be taken into account for tax purposes. Section 41 of the Internal Revenue Code of 1939

<sup>1</sup> Mertens Law of Federal Income Taxation (Zinn & Standley Rev. Stat., Vol. 2, § 12.01). "The fundamental questions of *when* items become income and *when* items are deductible, despite years of extensive litigation, are still troublesome today."



is the starting point in determining petitioner's "income" for purposes of the internal revenue laws. It directs that net income shall be *computed* on the basis of taxpayer's annual accounting period. "In accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income." Section 42 of the 1939 Code sets out the *period* in which items of gross income shall be recognized. It provides:

"The amount of all items of gross income shall be included in the gross income for the taxable year in [vol. 244] which received by the taxpayer, *unless*, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period." (Emphasis supplied.)

Regulations issued by the Commissioner reiterate the principle that the accounting methods and computations thereunder are to be made in a manner which will clearly reflect the taxpayer's income.

Regulations 118, issued under the 1939 Code provide [see Vol. 2, Mertens Law of Federal Income Taxation, § 12.02, p. 9]:

"\* \* \* The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

"It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his *true income*. He must, therefore, maintain such accounting records as will enable him to do so." (Emphasis supplied.)

As permitted by § 41, the practice of accrual accounting has long been recognized for the purpose of tax accounting. See *United States v. Anderson*, 290 U.S. 122, and 446(c) Internal Revenue Code of 1954. Generally, under such a system, it is contemplated that income, earned but not yet received, is to be reported, with the corresponding accrual of expenses incurred but not yet paid. It is not surprising that considerable litigation has arisen as to the proper treatment to be given specific items in specific instances.

One line of cases has dealt with the problem of *when* income accrues, and in this connection, the so called "claim of right" doctrine first made its appearance, apparently in *Noble American Oil Consolidated v. Barnett*, 286 U.S. 417. In that case, it was conceded that net profits earned by property in receivership during 1916 and paid over in 1917 constituted income. After holding that the income could not be said to have accrued during 1916, inasmuch as there was no constructive receipt of monies, nor right in taxpayer to demand the profits, the court further held that the profits were income for 1917, and not income for the year 1922, the year in which litigation was finally terminated, stating at p. 424:

"If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."

The "claim of right" test has been frequently applied, both from the standpoint of determining receipt of income, and of determining the propriety of deduction of expenses or reserves, and as to taxpayers on an accrual basis as well as to those on a cash basis. See and compare, *Brown v. Helvering*, 291 U.S. 193; *Spring City Co. v. Commissioner*, 292 U.S. 182; *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493; *Commissioner v. Hansen*, 350 U.S. 446, 463, 468; *Commissioner of Int. Rev. v. Cleveland Trust Co.*, 6 Cir., 62 F.2d 85. Recently, the Supreme Court,

in *Healy v. Commissioner*, 345 U.S. 278, had occasion to apply the test, in holding that cash basis taxpayers are required to report salaries when received although subsequently it was determined excessive salaries had been paid to them. There the Court stated, 345 U.S. at p. 281:

"Not infrequently, an adverse claimant will contest the right of the recipient to retain money or property [fol. 246] ery, either in the year of receipt or subsequently. In *North American Oil v. Barnett*, 286 U.S. 417, (1932), we considered whether such uncertainty would result in an amount otherwise includible in income being deferred as reportable income beyond the annual period in which received. That decision established the claim of right doctrine now deeply rooted in the federal tax system." (*United States v. Lewis*, 340 U.S. 590, 592)."

A second line of cases has dealt with the problem from the standpoint of the deductibility of anticipated expenses. See and compare, *United States v. Anderson*, 269 U.S. 422; *Spring City Co. v. Commissioner*, 292 U.S. 182; *McCauley Ward Motor Supply Co. v. Commissioner*, 10 B.T.A. 394; *Capital Warehouse Co. v. Commissioner of Internal Revenue*, 8 Cir., 171 F.2d 395; *Hilinski v. Commissioner of Internal Revenue*, 6 Cir., 237 F.2d 793. From these cases, the rule has evolved that no expense may be accrued and deducted in the absence of a fixed and definite liability for a sum which may be determined with reasonable certainty. Frequently in fixing a strict standard of proof, the courts speak in terms of deductions being a matter of "legislative grace," not a matter of right. See *U.S. v. Olympic Radio & Television*, 349 U.S. 232, 235; *Capital Warehouse Co. v. Commissioner of Internal Revenue*, *supra*, at p. 397.

There remains yet a third type of situation, typified by that before us—that is, the proper tax treatment of receipts which are in part unearned. It is our view that the concept of "prepaid receipts" requires consideration of factors not present in dealing with concededly earned income. However, it is apparent from our review of Tax Court decisions, that this distinction has not been made.

and that the Commissioner is unyielding in his position, which, broadly stated, is that all payments actually or constructively received by a taxpayer for future services, are taxable in the year of receipt, without regard to taxpayer's accounting system, and regardless of whether such receipts will be retained or offset by expenses in future years. See *Curtis R. Andrews v. Commissioner*, 23 T.C. 1026, and compare *Consolidated Edison Co. of New York v. United States*, 2 Cir., 279 F.2d 152, petition for certiorari pending, (pre payment of tax not yet accrued). On the other hand it is apparent that taxpayers have frequently found it difficult to obtain the Commissioner's approval of reserves set up and designed to offset the expenses of earning such income. See and compare, *Capital Warehouse Co. v. Commissioner of Internal Rev.*, supra, 174 F.2d 396; *Hilinski v. Commissioner of Internal Rev.*, supra, 237 F.2d at p. 704. It is our view that the decision in the case before us does not turn solely on the question of whether petitioners had the right to receive or keep the amounts of tuition designated in the contracts for lessons. The real question is whether petitioners' system of accounting reflected their true income. The Tax Court made no finding that it did not. The effect of the Commissioner's adherence to and application of the claim of right test, here, is to place petitioners on a cash basis as to income, irrespective of the fact that their books are kept on an accrual basis. It must be remembered that accrual accounting has been approved for the purpose of tax accounting. In the oft-cited case of *United States v. Anderson*, [vol. 248] supra, the Supreme Court discussed the

"It is not reasonable under these circumstances to compel the petitioners to accrue income and at the same time refuse to allow them to accrue the liability incurred in the production of that income."

Petitioners have argued with some persuasion that the "claim of right" doctrine will not extend to portions of the installment contracts not due or payable until a later year. Furthermore, as noted, the Tax Court found that petitioners' past experience indicated that a large portion of the sales would be cancelled. As to ownership of the reserves held by the bank, see and compare *Commissioner v. Hanson*, 260 U.S. 446. Because of our disposition of the case, it is not necessary to decide these issues.

Purpose of § 42(a) and 43(1) of the Revenue Act of 1916 (provisions similar to § 41, 42) in this language at p. 440 of 269 U.S.:

"It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis."

See also *United States v. Mitchell*, 271 U.S. 9, 12, 13; *Hepby v. Commissioner*, 345 U.S. 278, 281; *Hilinski v. Commissioner of Internal Revenue*, supra, at p. 704; and *Beacon Publishing Co. v. Commissioner of Internal Rev.*, 10 Cir., 218 F.2d 697, 699, where this pertinent statement appears: "The obvious purpose of these provisions (appearing in § 41 and 42) is to obtain from the taxpayer a return reflecting its true income and to treat income received and deductible disbursements consistently." *United States v. Mitchell*, 271 U.S. 9, 12, 46 S.Ct. 418, 70 L.Ed. 799.

In *Beacon Publishing Co. v. Commissioner of Internal Rev.*, supra; *Banshore Gardens, Inc. v. C.I.R.*, 2 Cir., 267 F.2d 55, and *Bressner Radio, Inc. v. C.I.R.*, 2 Cir., 267 F.2d 520, the courts effectuated the purpose of these provisions and reversed the Tax Court on the identical position here advanced, the holding being that it was proper under the accrual method of accounting to defer prepaid receipts. The courts have also recognized a corollary to the foregoing rule, that is, when the accrual method of accounting is employed, it is proper under appropriate circumstances to set up a reserve in the year of receipt to meet the expenses attributable to the income. See *Pacific Grape Prod. Co. v. Commissioner of Int. Rev.*, 9

It is significant that the language of § 41 is directed to net income, which necessarily contemplates the matching of receipts and expenses.

Cir., 249 F.2d 862; *Schlesinger v. Commissioner of Internal Revenue*, 5 Cir., 230 F.2d 722; *Harrold v. Commissioner of Internal Revenue*, 4 Cir., 192 F.2d 1002; *Hilinski v. Commissioner of Internal Revenue*, 6 Cir., 237 F.2d 763; *Denise Coal Company v. Commissioner*, 23 Cir., 271 F.2d 930. However, where there is a mere contingent liability to make refunds in the following year or doubt as to future services to be performed, reserves may not be deducted. *Beacon v. Helvering*, supra, at pp. 199, 202; *Seaton Mills Co. v. Commissioner*, 321 U.S. 281, 284; *Whitaker v. Commissioner of Internal Revenue*, 5 Cir., 259 F.2d 379, at 382, 384, and cf. *Capital Warehouse Co. v. Commissioner of Internal Revenue*, 8 Cir., 171 F.2d 395.

Many of the decisions relied upon by the Commissioner concerned fully executed contracts and concededly earned income. This factor has been thought to considerable discussion by many courts in arriving at their conclusions. See *Duchay v. Commissioner of Internal Revenue*, 22 Cir., 110 F.2d 157, cert. den., 311 U.S. 658; *Denise Coal Company v. C.I.R.*, 3 Cir., 271 F.2d 930; *Bard v. Commissioner of Internal Revenue*, 7 Cir., 256 F.2d 918, 924, aff'd, *Commissioner v. Hart*, 360 U.S. 446; *Universal Oil Products Co. v. Campbell*, 7 Cir., 181 F.2d 451, 469, 472, cert. den., 340 U.S. 850 (counting out that an agreement for services had been fully performed); and *Whitaker v. Commissioner of Internal Revenue*, 5 Cir., 259 F.2d 379, 384.

On the facts we have a case closely analogous to *Beacon Publishing Co. v. Commissioner of Internal Revenue*, supra;

In *Schlesinger v. Commissioner of Internal Revenue*, supra, the Court in discussing deductibility of anticipated expenses observed, 230 F.2d at p. 724:

"The decisions of the Tax Court and of the several Courts of Appeals are not uniform on this subject, some circuits requiring a mathematical certainty as to the exact amount of the future expenditures that cannot be satisfied in the usual case. Other circuits, seemingly more concerned with the underlying principle of charging to each year's income reasonably ascertainable future expenses necessary to earn or retain the income, have permitted the accrual of restricted items of future expenses. Two of this latter category are *Harrold v. Commissioner* and *Pacific Grape Products Co. v. Commissioner*."



*Bressner Radio, Inc. v. C.I.R.*, *supra*, and *Bayshore Gardens, Inc. v. C.I.R.*, *supra*, and on principle one that is identical with those cases. In *Bressner*, the Second Circuit, in a well reasoned, sound and exhaustive opinion, deals with all facets of the question. In our view, it is not only apposite but persuasive.

Even assuming arguendo that petitioners received cash payment in full at the time of contracting, the receipt of the funds could not be considered to be earned until petitioners had discharged their liabilities under the contract. Under their method of accounting, established when the partnership was formed and continually employed thereafter, petitioners reported as income in their tax returns such portion of the total amount received, as under their system of accounting had been earned, deferring the remainder of the amount received for inclusion in the year or years in which the remainder of their liability was discharged. Such system seems eminently designed to reflect true income.

[fol. 251] Manifestly, *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, the only case in which the Supreme Court considered on the merits the question of the propriety of deferring prepaid funds, is distinguishable and therefore not controlling. Although the Tax Court in that case applied the claim of right doctrine to disallow the deferral of unearned receipts, 20 T.C. 6033, *aff'd*, *sub nom. Automobile Club of Mich. v. Commissioner of Internal Rev.*, 6 Cir., 230 F.2d 585, 591, this question was not reached, for the Supreme Court delineated the issues and based its decision on the narrow ground that the particular method of deferral employed by the Club was unsatisfactory. The Court found that "the pro rata allocation of membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may

\* This is not a situation where taxpayers are attempting to change their method of accounting. See *Reynolds Helicopters*, 291 U.S. 163; *United States v. Anderson*, 269 U.S. 422; *Beacon Publishing Co. v. Commissioner of Internal Revenue*, *supra*, at pp. 701-702. Three qualified experts testified that the system here was a true measure of income.

in fact be called upon to render for the vendor." 359 U.S. at p. 180. The Court distinguished *B. & O. P. & L. Co. v. Commissioner of Internal Revenue*, supra, and *Schlesinger v. Commissioner of Internal Revenue*, supra, on their facts, expressing no opinion upon the correctness of those decisions.

The facts before us are distinguishable. Here, petitioner's obligation to provide services subsequent to the tax year was fixed, definite and certain, thereby effectively rebutting any contention that petitioner's method of deferral was purely artificial. The system and method of accounting on an accrual basis with the deferral of income so that it could be closely matched to the corresponding expenses was designed to clearly reflect petitioner's true income within the meaning of the applicable statutes and regulations. As pointed out in the *B. & O.* and *Schlesinger* cases, any other method would result in a distortion of true income. Compare *Wallington Realty Co. v. Tax Comm'n*, 252 U.S. 511, 18-20, 80-81, 245 F.2d 823, ruling that *pro rata* basis taxpayer was entitled to deduct *pro rata* share of insurance premiums in 1947 year paid against the Commissioner's contention that the cost thereof must be prorated over the term of the policy. This court observed at p. 825, "To require the taxpayer to treat its insurance payments upon an accrual basis would, as the Supreme Court states in *Schlesinger v. B. & O. P. & L. Co.*, supra, create a divided and inconsistent method of accounting not properly to be denominated either as cash or accrual system."

Nor do we regard *Capital Warehouse Co. v. Commissioner of Internal Revenue*, supra, its opposite, contrary, not enlightening. In that case the crucial question was whether the taxpayer could, for the first time, deduct, exclude from its gross income, that portion of the net which it had set aside on its books as a reserve fund to cover a contingent liability. As we understand the argument, the taxpayer was denied the deduction because the amount which it set aside in the reserve account was not paid and certain.

It is our view that the recent decision of the Seventh Circuit in *Streight Radio and Television, Inc. v. Commissioner*, — F.2d. —, decided July 28, 1960, and affirming the Tax Court, is analogous to the *Automobile Club of Michigan* holding, being based upon a finding that taxpayer's system of deferring income attributable to future services was arbitrary and without proper foundation. In referring to the decision of the Tax Court in the *Streight* case, 33 T.C. No. 15, at p. 11, we observe that that court found that the taxpayer had "failed to prove that the method of deferral used bore any significant relation to the services to be performed."

[fol. 253] Even indulging the assumption that petitioners came into possession of the monetary amount of the contracts when executed within the contemplation of the claim of right doctrine, we are satisfied that to apply the doctrine to petitioners' operation, without regard to its accrual system of accounting, would result in emasculation of the law long recognized, which affords taxpayers the right "to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." *United States v. Anderson*, supra, 269 U.S. at p. 440.

On this record we must hold that there is no showing that the method of accounting employed by taxpayers did not clearly reflect income, and consequently there is no basis for the Commissioner to adopt a method of his own. Accordingly, the decision of the Tax Court is

Reversed.

Woodruff, Circuit Judge, dissenting.

This Court twelve years ago considered the question that is the crux of the presently involved controversy in the case of *Capital Warehouse Co., Inc. v. Commissioner of Internal Revenue*, (C.A., 8, 1948) 171 F.2d 395.

In that case the taxpayer sought to exclude from its gross income that portion thereof which it had set aside on its books as a reserve to cover its contractual liabilities to its customers to remove merchandise from its [fol. 254] warehouses at the end of its storage period. The Tax Court held that the Commissioner rightfully refused to uphold the exclusion. We affirmed the decision of the Tax Court. Although other Courts of Appeals have since reached contrary conclusions, I would adhere to our former decision and affirm the Tax Court in this case.

I, Robert C. Tucker, Clerk, United States Court of Appeals for the 8th Circuit, do hereby certify that the foregoing is a true and complete copy of the opinion of this Court filed Oct. 19, 1960, but withdrawn by order of this Court of December 15, 1961, after remand of this case by the Supreme Court of the United States for further proceedings.

In Testimony Whereof, I herewith subscribe my name and affix the seal of the United States Court of Appeals for the Eighth Circuit, at office in the City of St. Louis, Missouri, this 1st day of June, A. D. 1962.

Robert C. Tucker, Clerk, U.S. Court of Appeals for the Eighth Circuit.

SEAL

is reported in 367 U.S. 911, rehearing was denied and per curiam order amended at 368 U.S. 873.

The prior opinion of the Court of Appeals for the Eighth Circuit dated October 19, 1960, is reported at 283 F.2d 234, and is printed as Appendix B hereto (p. 2a).

The Findings of Fact and Opinion of the Tax Court of the United States is reported in 32 T.C. 1271. (R. 203-221.)\*

### **JURISDICTION**

The judgment of the Court of Appeals was entered December 15, 1961. (Appendix C, p. 17a). The jurisdiction of this Court is invoked under 28 U.S.C. section 1254.

### **QUESTION PRESENTED**

The sole question for decision is:

Is income realized merely by signing a contract for the giving of dancing lessons?

The taxpayers maintain that income does not arise at the time the executory contracts are signed. Rather income arises at the time it is earned by the giving of the lessons under the accrual method of accounting.

The Commissioner says income is realized equal to the face amount of the executory contract at the time the contract is signed to teach dancing lessons in the future.

\* "R." references are to the record of the proceedings before the Tax Court, which have been filed as a part of the record in this Court.

## STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and of the Treasury Regulations are set forth in Appendix D. (pp. 18a-23a).

## STATEMENT

The pertinent facts may be summarized as follows (App. pp. 3a-6a):

Taxpayers, husband and wife, on June 18, 1946, formed a partnership known as Arthur Murray Dance Studio for the purpose of conducting and operating dance studios authorized by certain franchise agreements entered into with Arthur Murray, Inc., of New York City. The venture was carried into effect and the partnership operated studios in the States of Nebraska, Iowa and South Dakota, for the specific purpose of teaching private ballroom dancing to individual students. (R. 205-206)

Basically, there were two kinds of contracts entered into between the partnership and students desiring dancing instructions. Under one type, a portion of the total tuition was paid in cash when the contract was signed, and the balance paid subsequently in installments. Under the other, a portion of the down payment was paid in cash at the time the contract was entered into, and the balance of the down payment was to be paid in installments, the remainder of the contract price being evidenced by a negotiable note taken from the student, payable in designated installments in accordance with the terms of the note. Under the contract the student agreed to take a designated number of hours of dancing lessons and pay therefor the amount specified as tuition. All types of contracts contained



a non-cancellable provision and provided that the student should not be relieved of his obligation to pay the tuition agreed upon. The hours of lessons or instructions contracted for ranged from 5 to 1,000 or 1,200. Some of the contracts were for lifetime courses which meant that, over and above 1,200 specified hours, the student was entitled to 2 hours of lessons per month plus two parties a year for life. By explicit terms, the studio was required to give the number of hours of instruction agreed upon. The contracts, however, did not schedule the dates when the studio was required to give and the student was to receive instructions, this detail being arranged and agreed upon from time to time as lessons were given. (R. 207-208) However, every contract specifically provided for an expiration date. (R. 108, Exs. 15-C to 20-T, inclusive). Under many of the contracts, lessons extended beyond the fiscal year in which the contract had its inception. (R. 208)

Notes taken from students were transferred with full recourse to a local bank, which at the time of acquiring a note would deduct therefrom the interest charges and give approximately 50 per cent of the balance of the note to petitioners. Installment payments by students on the remainder of the note were held by the bank in a reserve account, but this reserve was not available to petitioners until the note was paid in full by the student, after which the reserve was transferred to the partnership's general bank account. (R. 208)

A sizeable number of contracts was cancelled annually, the non-cancellable provision to the contrary notwithstanding. In its opinion, the Tax Court found

IN THE  
**Supreme Court of the United States**

October Term, 1964

No. **793**

MARK E. SCHULDE AND MARGARET SCHULDE

COMMISSIONER OF INTERNAL REVENUE

**PETITION FOR WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS FOR  
THE EIGHTH CIRCUIT**

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*Of Counsel:*

ASH, BAILESELD & BERDON

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IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1961

No.

MARK E. SCHULDE AND MARZAH SCHULDE

v.

COMMISSIONER OF INTERNAL REVENUE

**PETITION FOR WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS FOR  
THE EIGHTH CIRCUIT**

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered December 15, 1961.

**PRIOR OPINIONS**

The per curiam opinion of the Court of Appeals on remand dated December 15, 1961, is unreported and is printed in Appendix A hereto (p. 1a).

The per curiam opinion of this Court dated June 19, 1961 granting certiorari and remanding the case,

that "cancellations were considerable in amount," noting that records of the partnership disclosed that cancellations for the respective years involved were 17 per cent, 15 per cent, and 19 per cent of sales for the respective years.<sup>1</sup> (R. 215)

A complete double entry bookkeeping system was installed for the partnership by a certified public accounting firm at the time that the partnership was organized, and an accrual system of accounting was employed, with the fiscal year ending March 31. This accounting system was used continually and consistently from the time the partnership was formed. Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract. (R. 209).

When a contract was entered into with a student, the "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and determination was made of the number of hours of lessons taught which, multiplied by the rate per hour of each contract, gave the amount of income earned. The deferred income account was then reduced by that amount and an earned income account increased by the same amount. Earned income thus arrived at was reported as income on the partnership's tax return. If there was any gain resulting from the cancellation of a con-

<sup>1</sup> Petitioners contend that the Tax Court's percentages of cancellation are inaccurate; sales in the amount of approximately 28.4 per cent, 14.1 per cent and 25.2 per cent were cancelled in the fiscal years 1952, 1953 and 1954. (R. 152; Pet. Ex. 24)

tract, this amount was also considered as taxable income and reported as such. (R. 209-210)<sup>2</sup>

Three qualified accounting experts testified that the system of accounting employed by taxpayers did reflect true income and was the only method which would do so. The Tax Court made no finding that taxpayers' system of accounting did not reflect their true income. (R. 205-214, 154-156, 190-192, 199-200.)

Under the Commissioner's method of computing income, this successful and growing business would have had an actual cash deficit of \$15,259.92 at the end of the fiscal year ended March 31, 1954. As of the same date, the partnership was under the contractual obligation to teach 31,677 hours of dancing which would have cost over \$250,000. (R. 167-169.)

The Commissioner determined that the entire amount of the contract price was income in the year in which the contract was entered into. (R. 215). Accordingly, in his notices of deficiency he increased the ordinary net income of the partnership for the fiscal years involved by the amounts of the increases in the "deferred income" account in those years. (R. 213). The deficiencies resulting from such increases in the deferred income account in the fiscal years ended March 31, 1952, 1953 and 1954 are as follows: \$24,602.22 in 1952, \$104,798.41 in 1953, and \$12,797.97 in 1954. (R. 213). The Tax Court, three Judges dissenting, sustained the Commissioner's determination through application of the "claim of right doctrine," meaning

<sup>2</sup> Detailed schedules which correctly and precisely reflect the result of the partnership's accrual system of accounting during the years in question appear in the findings of fact of the Tax Court. (R. 210-214.)



that, for income tax purposes, the full amount of a contract price had to be returned as income in the year in which the contract was entered into, irrespective of the amount of money collected and irrespective of the actual rendering of service or of any obligation on the part of the partnership to render services under the contract in years subsequent to the year in which the agreement was made. (R. 203-221). The Court of Appeals, one Judge dissenting, on October 19, 1960, reversed the Tax Court. (App. pp. 3a-16a). The Court in part stated: (App. p. 13a)

"Even assuming arguendo that petitioners received cash payment in full at the time of contracting, the receipt of the funds could not be considered to be earned until petitioners had discharged their liabilities under the contract. Under their method of accounting, established when the partnership was formed and continually employed thereafter, petitioners reported as income in their tax returns such portion of the total amount received, as under their system of accounting had been earned, deferring the remainder of the amount received for inclusion in the year or years in which the remainder of their liability was discharged. Such system seems eminently designed to reflect true income."

"This is not a situation where taxpayers are attempting to change their method of accounting. See *Beaton v. Helvering*, 291 U.S. 193, 197, 54-1 USTC ¶10,000, 29 TC 122 (1945), *Beaton Publishing Co. v. Commissioner of Internal Revenue*, supra, at pp. 791-792. Three qualified experts testified that the system here employed did reflect true income and in fact was the only method which would do so."

On June 19, 1961, this Court granted the Commissioner's petition for certiorari, and in a per curiam decision vacated the judgment and remanded the case.

in the light of *American Automobile Association v. United States*, 367 U.S. 687 (1961). On petition for rehearing this Court, on October 9, 1961, denied the petition for a rehearing and amended its per curiam order by remanding the case "for further consideration in light of *American Automobile Association v. United States*." On December 15, 1961, the Court of Appeals in a per curiam opinion held that "In the light of that case [*American Automobile Association*] we have carefully examined and considered petitioners' method of accrual accounting and are convinced that such method does not, for income tax purposes clearly reflect income," and vacated its previous judgment and affirmed the decision of the Tax Court.

#### REASONS FOR GRANTING THE WRIT

1. The Court of Appeals erred in holding that in the light of the case of *American Automobile Association*, the taxpayer's method of accrual accounting does not for income tax purposes clearly reflect income. The Court of Appeals has misapplied the holding of this Court in the *American Automobile Association* case to the entirely different factual situation than that which exists in the case at bar. There are many important factual distinctions between the *American Automobile Association* case and the case at bar.

(a) In the case at bar, the Tax Court held that the entire contract price is income when the contract was signed even though the contracts were executory in that many payments were not to be made until a subsequent taxable year and were not due until such subsequent year. (See dissenting opinion of three Tax Court Judges. R. 219-221.) In addition, many of the dancing lessons were not to be given until a subse-

quent year. In the *American Automobile Association* case the Court was dealing only with actual cash money paid to the Association for which there may or may not have been future services required.

The taxpayers derive income from the teaching of ballroom dancing, not from the signing of contracts. The signing of an executory contract, wherein a student promises to pay for lessons to be given in the future, does not meet the definition of when income accrues as stated in *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184, as follows:

"Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues."

While the contracts were executory, no income was earned and, consequently, could not accrue. *United States v. Anderson*, (1926), 269 U.S. 422. The event giving rise to the income was the giving of the dancing lessons. Until the lessons were given there was no "right to receive" an amount which had become fixed within the meaning of the accrual accounting concept. Cf. *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182. By taking into account gross income in the year earned and the expense in the year incurred, there was a matching of gross income with related costs and expense applicable to the process of earning that income and therefore a true determination of taxpayers' net income.

(b) To the extent that cash was actually received on the dancing contracts during the year, the important

factual distinctions are that in the case at bar (1) there was no pro rata allocation of income to periods on a time elapsed basis; (2) there was no pooling of expenses or a deduction of expenses on a pro rata basis; (3) there was no computation of profits based on average experience in rendering services or performance, and (4) there was no selling of availability of services. In the case at bar, (1) income is returned in the year of actual performance; (2) expenses are deducted when incurred; (3) profit is computed on the basis of actual events or transactions and the exchange of values, and (4) actual services are sold which can be identified for each contract as to the amount of performance rendered and the amount of performance yet to be rendered. Consequently, the case at bar falls within the rules of *Beacon Publishing Company v. Commissioner*, (C.A. 10, 1955) 218 F. 2d 697, and *Schuessler v. Commissioner*, (C.A. 5, 1956) 230 F. 2d 722, because the studio rendered actual dancing instructions to its students on fixed dates as scheduled, in accordance with the terms of the contracts. This is the principle on which this Court distinguished the *Automobile Club of Michigan* case and the *American Automobile Association* case from the *Beacon* and *Schuessler* cases.

In the *American Automobile Association* case, the taxpayer failed to prove that the method of deferral used bore any significant relation to the services to be performed in the future. In the instant case the deferral bears a direct relation to the services to be performed and which are in fact required to be performed under the terms of the contract. The studio's obligation to provide services subsequent to the tax year was fixed, definite and certain and furthermore

was identifiable as to untaught hours and unearned contract amount for each student contract outstanding at the end of the year.

2. The decision below is in conflict in principle with the decision of this Court in *United States v. Anderson*, (1926) 269 U.S. 422, where the purpose of the accrual method of accounting was stated as follows:

\*\*\* \* \* It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period:  
\* \* \*

The decision below is also in conflict with the decisions of the Fifth and Tenth Circuits in the cases of *Schuessler v. Commissioner*, (C.A. 5; 1956) 230 F. 2d 722, and *Beacon Publishing Company v. Commissioner*, (C.A. 10, 1955) 218 F. 2d 697. In *Automobile Club of Michigan v. Commissioner*, (1957) 353 U.S. 180, this Court distinguished the *Beacon* and *Schuessler* cases from the *Automobile Club of Michigan* on its facts by pointing out that performance of the subscription, in those cases, was, in part, necessarily deferred until the publication dates after the tax year. In *Schuessler* it was pointed out that performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year. In the *Automobile Club* cases substantially all the services were performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year. In the case at bar, the dancing students do not buy the availability of services. They buy the actual dancing instruction itself. In the

*Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, the Court found that (p. 189) "the pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member." This is not the situation in the case at bar. The Court of Appeals in its original opinion in the case at bar pointed this out and said: (App. 14a)

"The facts before us are distinguishable. Here, petitioners' obligation to provide services subsequent to the tax year was fixed, definite and certain, thereby effectively rebutting any contention that petitioners' method of deferral was purely artificial. The system and method of accounting on an accrual basis with the deferral of income so that it could be closely matched to the corresponding expenses, was designed to clearly reflect petitioners' true income within the meaning of the applicable statutes and regulations. As pointed out in the *Beacon* and *Schuessler* cases, any other method would result in a distortion of true income."

3. The problems presented for review by this Court are of substantial and continuing importance, both to the government and to taxpayers. This is true because most American business concerns use the accrual system of accounting. In any case in which it is necessary to use an inventory the regulations specifically require that taxpayers use the accrual system. Treas. Reg. 118, sec. 39.41-2. If the *American Automobile Association* decision is construed to mean, as the Courts below have construed it, that the full amounts of the contracts are income and taxable in the year the contracts are signed irrespective of when payment is made



or is due to be made, and irrespective of time of performance by the taxpayer under the contract it will raise havoc with American business. Illustrations are service contracts for long term maintenance service, contracts providing advertising services over extended periods, or manufacturers and merchants who receive sales contracts in advance of the shipment or delivery of their products, or, as pointed out in Judge Pierce's dissenting opinion in the Tax Court, the mere signing of a lease might hereafter result in accruing as income at the time the lease was executed all rental payments contracted to be made in subsequent years under such lease. If the Eighth Circuit's interpretation is permitted to stand, expenses will be incurred in performing contracts when no "income" will be available to offset the expenses, and more importantly, no income will have been earned under such contracts. Such a rule does violence, not only with the accrual method of accounting now used by most American business concerns, but to the Internal Revenue Code, Treasury Regulations and the rule of *United States v. Anderson*, (1926) 269 U.S. 422, which expresses the rule of accrual accounting that expenses incurred in earning income should be charged against income earned.

### CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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*Attorneys for Petitioners*

March 15, 1962

## APPENDIX A

UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

No. 16,443

MARK E. SCHLUDER AND MARZALIE SCHLUDER,  
Husband and Wife, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petition to Review Decision of The Tax Court  
of the United States

[December 15, 1961.]

Before SANDERS, VAN OSTERHOUT and MATTHEIS, Circuit  
Judges.

PER CURIAM.

For the second time this case is here for determination. Our first opinion, 283 F. 2d 234, reversed the decision of the Tax Court. On June 19, 1961, the Supreme Court of the United States rendered its decision in *American Automobile Association v. United States*, 367 U.S. 687. On the same day the Supreme Court, by per curiam order in this case, directed that "(t)he judgment is vacated and the case is remanded in light of *American Automobile Association v. United States* \* \* \*." *Commissioner of Internal Revenue v. Schluder et al.*, 367 U.S. 911. On October 9, 1961, in denying petition for rehearing, the Supreme Court amended its per curiam order of June 19, 1961, as follows: "The judgment is vacated and the case is remanded for further consideration in the light of *American Automobile Association v. United States* \* \* \*." (Emphasis supplied).

Pursuant to our invitation, counsel for petitioners and the Commissioner filed supplemental briefs and presented

oral arguments directed largely to the question of whether this case falls within the ambit of the teachings of *American Automobile Association*, supra. In light of that case we have carefully examined and considered petitioners' method of accrual accounting and are convinced that such method does not, for income tax purposes, clearly reflect income.

Accordingly, our judgment previously entered is vacated, and the decision of the Tax Court is affirmed.

A true copy.

Attest:

*Clerk U. S. Court of Appeals, Eighth Circuit.*

## APPENDIX B

UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

No. 16,443

MARK E. SCHLUDE AND MARZALIE SCHLUDE,  
Husband and Wife, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Petition to Review Decisions of the Tax Court  
of the United States

[October 19, 1960.]

Before SANBORN, WOODBROUGH, and MATTHES, Circuit  
Judges.

MATTHES, Circuit Judge.

The Commissioner of Internal Revenue determined that a deficiency existed in the tax liability of petitioners for the years 1952 to 1954, inclusive, as follows:

Mark E. Schlude for 1952 .....	\$ 9,264.69
Marzalie Schlude for 1952 .....	1,971.55
Mark E. and Marzalie Schlude for 1953 .....	8,395.82
Mark E. and Marzalie Schlude for 1954 .....	11,544.32

The Tax Court, with three Judges dissenting, affirmed the action of the Commissioner. See 32 T.C. 1271. Pursuant to §§ 1141, 1142 of the Internal Revenue Code of 1939 and §§ 7482, 7483 of the 1954 Code, petitioners have brought the case to this Court for review.

The facts, established by stipulation of the parties and evidence, are detailed in the findings of the Tax Court. Those essential to a proper understanding of the question presented for our determination are: Petitioners, husband and wife, on June 18, 1946, formed a partnership known as Arthur Murray Dance Studio for the purpose of conducting and operating dance studios authorized by certain franchise agreements entered into with Arthur Murray, Inc., of New York City. The venture was carried into effect and the partnership operated studios in the States of Nebraska, Iowa and South Dakota, for the specific purpose of teaching private ballroom dancing to individual students.

Basically, there were two kinds of contracts entered into between the partnership and students desiring dancing instructions. Under one type, a portion of the total tuition was paid in cash when the contract was executed, and the balance in deferred installments. Under the other, a portion of the down payment was paid in cash at the time the contract was entered into, and the balance of the down payment was to be paid in installments, the remainder of the contract price being evidenced by a negotiable note taken from the student, payable in designated installments in accordance with the terms of the note. Under the contract the student agreed to take a designated number of hours of dancing lessons and pay therefor the amount

specified as tuition. All types of contracts contained a non-cancellable provision and provided that the student should not be relieved of his obligation to pay the tuition agreed upon. The hours of lessons or instructions contracted for ranged from 5 to 1,000 to 1,200. Some of the contracts were for lifetime courses which meant that, over and above 1,200 specified hours, the student was entitled to 2 hours of lessons per month plus two parties a year for life. By explicit terms, the studio was required to give the number of hours of instruction agreed upon. The contracts, however, did not schedule the dates when the studio was required to give and the student was to receive instructions, this detail being arranged and agreed upon from time to time as lessons were given. Under many of the contracts, lessons extended beyond the fiscal year in which the contract had its inception.

Notes taken from students were transferred with full recourse, to a local bank, which at the time of acquiring a note, would deduct therefrom the interest charges, and give approximately 50% of the balance of the note to petitioners. Installment payments on the remainder of the note were held by the bank in a reserve account, but this reserve was not available to petitioners until the note was paid in full by the student, after which the reserve was transferred to the partnership's general bank account.

A sizeable number of contracts was cancelled annually, the non-cancellable provision to the contrary notwithstanding. In its opinion, the Tax Court conceded that "cancellations were considerable in amount", noting that records of the partnership disclosed that cancellations for the respective years involved were 17%, 15%, and 19% of sales for the respective years.<sup>1</sup>

<sup>1</sup> 32 T.C. at p. 1279. Petitioners insist that the Tax Court's percentages of cancellations are inaccurate; that sales in the amount of approximately 28.4%, 19.1% and 25.2% were cancelled in the fiscal years 1952, 1953 and 1954.

A complete double entry bookkeeping system was installed for the partnership by a certified public accounting firm at the time that the partnership was organized, and an accrual system of accounting was employed, with the fiscal year ending March 31. This accounting system was used continually and consistently from the time the partnership was formed. Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract.

Since the method pursued by the partnership with respect to its operations under its accrual system of accounting and the effect thereof from an income tax standpoint are fully and correctly shown in the findings of the Tax Court, we shall forego a repetitious analysis of the manner in which the student transactions were processed insofar as they bear upon the tax question. It is sufficient to say that when a contract was entered into with a student, the "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and determination was made of the number of hours of lessons taught which, multiplied by the rate per hour of each contract, gave the amount of income earned. This amount was then charged to "deferred income" and credited to "earned income." Earned income thus arrived at was reported as income on the partnership's tax return. If there was any gain resulting from cancellation of a contract, this amount was also considered as taxable income and reported as such. Detailed schedules which correctly and precisely reflect the result of the partnership's accrual system of accounting during the years in question appear in the findings of fact of the Tax Court.

The deficiencies under consideration resulted from the Commissioner increasing the ordinary *net* income of the



partnership for the fiscal years ending March 31, 1952, 1953 and 1954, by the amount of the increases in the deferred income account in those years, as follows: \$24,602.22 in 1952, \$104,798.41 in 1953, and \$12,797.97 in 1954. This determination was made and upheld by the Tax Court through application of the "claim of right doctrine," meaning that, for income tax purposes, the full amount of its contract price had to be returned as income in the year in which the contract was entered into, irrespective of any obligation on the part of the partnership to render services under the contract in years subsequent to the year in which the agreement was made.

This case once more brings into sharp focus the question of when income shall be taken into account for tax purposes.<sup>2</sup> Section 41 of the Internal Revenue Code of 1939<sup>3</sup> is the starting point in determining petitioners' "income" for purposes of the internal revenue laws. It directs that net income shall be *computed* on the basis of taxpayer's annual accounting period, "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but \* \* \* if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as *in the opinion of the Commissioner* does clearly reflect the income." Section 42 of the 1939 Code sets out the *period* in which items of gross income shall be recognized. It provides:

"The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless*, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period." (Emphasis supplied.)

<sup>2</sup> Mertens Law of Federal Income Taxation (Zimet & Stanley Rev.) states, Vol. 2, § 12.01: "The fundamental questions of *when* items become income and *when* items are deductible, despite years of extensive litigation, are still troublesome today."

Regulations issued by the Commissioner reiterate the principle that the accounting methods and computations thereunder are to be made in a manner which will clearly reflect the taxpayer's income.<sup>2</sup>

As permitted by § 44, the practice of accrual accounting has long been recognized for the purpose of tax accounting. See *United States v. Anderson*, 269 U.S. 422; and § 446(c) Internal Revenue Code of 1954. Generally, under such a system, it is contemplated that income, earned but not yet received, is to be reported, with the corresponding accrual of expenses incurred but not yet paid. It is not surprising that considerable litigation<sup>3</sup> has arisen as to the proper treatment to be given specific items in specific instances.

One line of cases has dealt with the problem of *when* income accrues, and in this connection, the so-called "claim

<sup>2</sup> Regulations 118, issued under the 1939 Code provide (see Vol. 2, Mertens Law of Federal Income Taxation, § 12.02, p. 91):

\* \* \* The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

\* \* \* \* \*

"It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his *true income*. He must, therefore, maintain such accounting records as will enable him to do so." (Emphasis supplied).

of right" doctrine first made its appearance, apparently in *North American Oil Consolidated v. Burnet*, 286 U.S. 417. In that case, it was conceded that net profits earned by property in receivership during 1916 and paid over in 1917 constituted income. After holding that the income could not be said to have accrued during 1916, inasmuch as there was no constructive receipt of monies, nor right in taxpayer to demand the profits, the court further held that the profits were income for 1917, and not income for the year 1922, the year in which litigation was finally terminated, stating at p. 424:

"If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."

The "claim of right" test has been frequently applied both from the standpoint of determining receipt of income, and of determining the propriety of deduction of expenses or reserves, and as to taxpayers on an accrual basis as well as to those on a cash basis. See and compare, *Braun v. Helvering*, 291 U.S. 193; *Spring City Co. v. Commissioner*, 292 U.S. 182; *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493; *Commissioner v. Hansen*, 360 U.S. 446, 463, 468; *Commissioner of Int. Rev. v. Cleveland Trinidad Par. Co.*, 62 Cir., 62 F. 2d 85. Recently, the Supreme Court, in *Healy v. Commissioner*, 345 U.S. 278, had occasion to apply the test, in holding that cash basis taxpayers are required to report salaries when received although subsequently it was determined excessive salaries had been paid to them. There the Court stated, 345 U.S. at p. 284:

"Not infrequently, an adverse claimant will contest the right of the recipient to retain money or property, either in the year of receipt or subsequently. In

*North American Oil v. Burnet*, 286 U.S. 417 (1932), we considered whether such uncertainty would result in an amount otherwise includible in income being deferred as reportable income beyond the annual period in which received. That decision established the claim of right doctrine now deeply rooted in the federal tax system." (*United States v. Lewis*, 340 U.S. 590, 592)."

A second line of cases has dealt with the problem from the standpoint of the deductibility of anticipated expenses. See and compare, *United States v. Anderson*, 290 U.S. 422; *Spring City Co. v. Commissioner*, 292 U.S. 182; *McCaulley-Ward Motor Supply Co. v. Commissioner*, 10 B.T.A. 394; *Capital Warehouse Co. v. Commissioner of Internal Revenue*, 8 Cir., 171 F. 2d 395; *Hilinski v. Commissioner of Internal Revenue*, 6 Cir., 237 F. 2d 763. From these cases, the rule has evolved that no expense may be accrued and deducted in the absence of a fixed and definite liability for a sum which may be determined with reasonable certainty. Frequently in fixing a strict standard of proof, the courts speak in terms of deductions being a matter of "legislative grace;" not a matter of right. See *F. S. v. Olympic Radio & Television*, 349 U.S. 232, 235; *Capital Warehouse Co. v. Commissioner of Internal Rev.*, *supra*, at p. 397.

There remains yet a third type of situation, typified by that before us—that is, the proper tax treatment of receipts which are in part unearned. It is our view that the concept of "prepaid receipts" requires consideration of factors not present in dealing with concededly "earned income." However, it is apparent from our review of Tax Court decisions, that this distinction has not been made, and that the Commissioner is unyielding in his position, which, broadly stated, is that all payments actually or constructively received by a taxpayer for future services, are taxable in the year of receipt, without regard to taxpayer's accounting system, and regardless of whether such

receipts will be retained or offset by expenses in future years. See *Curtis R. Andrews v. Commissioner*, 23 T.C. 1026, and compare *Consolidated Edison Co. of New York v. United States*, 2 Cir., 279 F. 2d 152, petition for certiorari pending, (pre-payment of tax not yet accrued). On the other hand, it is apparent that taxpayers have frequently found it difficult to obtain the Commissioner's approval of reserves set up and designed to offset the expenses of earning such income. See and compare, *Capital Warehouse Co. v. Commissioner of Internal Rev.*, supra, 171 F. 2d 395; *Hilinski v. Commissioner of Internal Revenue*, supra, 237 F. 2d at p. 704.<sup>4</sup> It is our view that the decision in the case before us does not turn solely on the question of whether petitioners had the right to receive or keep the amounts of tuition designated in the contracts for lessons.<sup>5</sup> The real question is whether petitioners' system of accounting reflected their true income. The Tax Court made no finding that it did not. The effect of the Commissioner's adherence to and application of the claim of right test here is to place petitioners on a cash basis as to income, irrespective of the fact that their books are kept on an accrual basis. It must be remembered that accrual accounting has been approved for the purpose of tax accounting. In the oft-cited case of *United States v. Anderson*, supra, the Supreme Court discussed the purpose

<sup>4</sup> "It is not reasonable under these circumstances to compel the petitioners to accrue income and at the same time refuse to allow them to accrue the liability incurred in the production of that income."

<sup>5</sup> Petitioners have argued with some persuasion that the "claim of right" doctrine will not extend to portions of the installment contracts not due or payable until a later year. Furthermore, as noted, the Tax Court found that petitioners' past experience indicated that a large portion of the sales would be cancelled. As to ownership of the reserves held by the bank, see and compare *Commissioner v. Hansen*, 360 U.S. 446. Because of our disposition of the case, it is not necessary to decide these issues.

of §§ 12(a) and 13(d) of the Revenue Act of 1916 (provisions similar to §§ 41, 42) in this language at p. 440 of 260 U.S.:

"It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis."

See also *United States v. Mitchell*, 271 U.S. 9, 12, 13; *Healy v. Commissioner*, 345 U.S. 278, 281; *Hilgtski v. Commissioner of Internal Revenue*, supra, at p. 704; and *Beacon Publishing Co. v. Commissioner of Internal Revenue*, 10 Cir., 218 F. 2d 697, 699, where this pertinent statement appears: "The obvious purpose of these provisions (appearing in §§ 41 and 42) is to obtain from the taxpayer a return reflecting its true income and to treat income received and deductible disbursements consistently." *United States v. Mitchell*, 271 U.S. 9, 12, 46 S. Ct. 418, 70 L. Ed. 799.<sup>9</sup>

In *Beacon Publishing Co. v. Commissioner of Internal Revenue* supra; *Banshore Gardens, Inc. v. C.I.R.*, 2 Cir., 267 F. 2d 55, and *Bressner Radio, Inc. v. C.I.R.*, 2 Cir., 267 F. 2d 529, the courts effectuated the purpose of these provisions and reversed the Tax Court on the identical position here advanced, the holding being that it was proper under the accrual method of accounting to defer prepaid receipts. The courts have also recognized a corollary to the foregoing rule, that is, when the accrual method of accounting is employed, it is proper under appropriate circumstances to set up a reserve in the year of receipt to meet the ex-

<sup>9</sup> It is significant that the language of § 41 is directed to net income, which necessarily contemplates the matching of receipts and expenses.



penses attributable to the income. See *Pacific Grape Prod. Co. v. Commissioner of Int. Rev.*, 9 Cir., 219 F. 2d 862; *Schuessler v. Commissioner of Internal Revenue*, 5 Cir., 230 F. 2d 722; *Harrold v. Commissioner of Internal Revenue*, 4 Cir., 192 F. 2d 1002; *Hilinski v. Commissioner of Internal Revenue*, 6 Cir., 237 F. 2d 703; *Denise Coal Company v. Commissioner*, 3 Cir., 271 F. 2d 930. However, where there is a mere contingent liability to make refunds in the following year or doubt as to actual services to be performed, reserves may not be deducted. *Brown v. Helvering*, supra, at pp. 199-202; *Security Mills Co. v. Commissioner*, 321 U.S. 281, 284; *Whitaker v. Commissioner of Internal Revenue*, 5 Cir., 259 F. 2d 379 at 382, 384, and cf. *Capital Warehouse Co. v. Commissioner of Internal Rev.*, 8 Cir., 171 F. 2d 395.<sup>7</sup>

Many of the decisions relied upon by the Commissioner concerned fully executed contracts and concededly earned income. This factor has been treated to considerable discussion by many courts in arriving at their conclusions. See *Doule v. Commissioner of Internal Revenue*, 2 Cir., 130 F. 2d 157, cert. den. 311 U.S. 658; *Denise Coal Company v. C.I.R.*, 3 Cir., 271 F. 2d 930; *Baird v. Commissioner of Internal Revenue*, 7 Cir., 256 F. 2d 918, 924, aff'd, Com-

<sup>7</sup> In *Schuessler v. Commissioner of Internal Revenue*, supra, the Court in discussing deductibility of anticipated expenses observed, 230 F. 2d at p. 724:

"The decisions of the Tax Court and of the several Courts of Appeals are not uniform on this subject, some circuits requiring a mathematical certainty as to the exact amount of the future expenditures that cannot be satisfied in the usual case. Other circuits, seemingly more concerned with the underlying principle of charging to each year's income reasonably ascertainable future expenses necessary to earn or retain the income, have permitted the accrual of restricted items of future expenses. Two of this latter category are *Harrold v. Commissioner* and *Pacific Grape Products Co. v. Commissioner*."

*Commissioner v. Hanson*, 360 U.S. 446; *Universal Oil Products Co. v. Campbell*, 7 Cir., 481 F. 2d 451, 469, 472, cert. den., 340 U.S. 850 (pointing out that an agreement for services had been fully performed); and *Whitaker v. Commissioner of Internal Revenue*, 5 Cir., 250 F. 2d 379, 384.

On the facts we have a case closely analogous to *Benton Publishing Co. v. Commissioner of Internal Rev.*, supra; *Bressner Radio, Inc. v. C.I.R.*, supra, and *Banshaw Gaylens, Inc. v. C.I.R.*, supra, and on principle one that is identical with those cases. In *Bressner*, the Second Circuit, in a well reasoned, sound and exhaustive opinion, deals with all facets of the question. In our view, it is not only apposite but persuasive.

Even assuming arguendo that petitioners received cash payment in full at the time of contracting, the receipt of the funds could not be considered to be earned until petitioners had discharged their liabilities under the contract. Under their method of accounting, established when the partnership was formed and continually employed thereafter, petitioners reported as income in their tax returns such portion of the total amount received as under their system of accounting had been earned, deferring the remainder of the amount received for inclusion in the year or years in which the remainder of their liability was discharged. Such system seems eminently designed to reflect true income.

Manifestly, *Automobile Club of Michigan v. Commissioner*, 333 U.S. 180, the only case in which the Supreme Court considered on the merits the question of the pro-

This is not a situation where taxpayers are attempting to change their method of accounting. See *Beauchamp v. Helvering*, 291 U.S. 193; *United States v. Anderson*, 290 U.S. 422; *Benton Publishing Co. v. Commissioner of Internal Rev.*, supra, at pp. 700-702. Three qualified experts testified that the system here employed did reflect true income and in fact was the only method which would do so.

priety of deferring prepaid funds, is distinguishable and therefore not controlling. Although the Tax Court in that case applied the claim of right doctrine to disallow the deferral of unearned receipts, 20 T.C. 1033, *aff'd*, sub nom *Automobile Club of Mich. v. Commissioner of Int. Rev.*, 6 Cir., 230 F. 2d 585, 591, this question was not reached, for the Supreme Court delineated the issues and based its decision on the narrow ground that the *particular method* of deferral employed by the Club was unsatisfactory. The Court found that "(t)he pro rata allocation of membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member." 353 U.S. at p. 189. The Court distinguished *Beacon Publishing Co. v. Commissioner of Internal Revenue*, supra, and *Schuessler v. Commissioner of Internal Revenue*, supra, on their facts, expressing no opinion upon the correctness of these decisions.

The facts before us are distinguishable. Here, petitioners' obligation to provide services subsequent to the tax year was fixed, definite and certain, thereby effectively rebutting any contention that petitioners' method of deferral was purely artificial. The system and method of accounting on an accrual basis with the deferral of income, so that it could be closely matched to the corresponding expenses, was designed to clearly reflect petitioners' true income within the meaning of the applicable statutes and regulations. As pointed out in the *Beacon* and *Schuessler* cases, any other method would result in a distortion of true income. Compare *Waldheim Realty & Inv. Co. v. Commissioner of Int. Rev.*, 8 Cir., 245 F. 2d 823, ruling that a cash basis taxpayer was entitled to deduct *prepaid expenses* of insurance premiums in the year paid against the Commissioner's contention that the cost thereof must be pro-rated over the term of the policy. This court observed, at p. 828, "To require the taxpayer to treat its insurance payments upon an accrual basis would, as the Supreme Court

states in *Security Flour Mills Co.*, supra, create "a divided and inconsistent method of accounting not properly to be denominated either a cash or accrual system."

Neither do we regard *Capital Warehouse Co. v. Commissioner of Internal Rev.*, supra, as apposite, certainly not controlling. In that case the crucial question was whether the taxpayer could, for the tax year involved, exclude from its gross income that portion thereof which it had set aside on its books as a reserve fund to cover a contractual liability. As we understand the opinion, the taxpayer was denied the deduction because the amount which it had set up in the reserve account was not fixed and certain.

It is our view that the recent decision of the Seventh Circuit in *Streight Radio and Television, Inc. v. Commissioner*, . . . F. 2d . . . decided July 28, 1960, and affirming the Tax Court, is analogous to the *Automobile Club of Michigan* holding, being based upon a finding that taxpayer's system of deferring income attributable to future services was arbitrary and without proper foundation. In referring to the decision of the Tax Court in the *Streight* case, 33 T.C. No. 15, at p. 11, we observed that that court found that the taxpayer had "failed to prove that the method of deferral used bore any significant relation to the services to be performed."

Even indulging the assumption that petitioners came into possession of the monetary amount of the contracts when executed within the contemplation of the claim of right doctrine, we are satisfied that to apply the doctrine to petitioners' operation, without regard to its accrual system of accounting, would result in emasculation of the law long recognized, which affords taxpayers the right "to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income dur-

ing that period." *United States v. Anderson*, supra, 269 U.S. at p. 440.

On this record we must hold that there is no showing that the method of accounting employed by taxpayers did not clearly reflect income, and consequently there is no basis for the Commissioner to adopt a method of his own. Accordingly, the decision of the Tax Court is

Reversed.

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Woodworth, Circuit Judge, dissenting.

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This Court twelve years ago considered the question that is the crux of the presently involved controversy in the case of *Capital Warehouse Co., Inc. v. Commissioner of Internal Revenue*, (C.A. S. 1948) 171 F. 2d 395.

In that case the taxpayer sought to exclude from its gross income that portion thereof which it had set aside on its books as a reserve to cover its contractual liabilities to its customers to remove merchandise from its warehouse at the end of its storage period. The Tax Court held that the Commissioner rightfully refused to uphold the exclusion. We affirmed the decision of the Tax Court. Although other Courts of Appeals have since reached contrary conclusions, I would adhere to our former decision and affirm the Tax Court in this case.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eight Circuit.

## APPENDIX C

## Judgment

UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

No. 16443, September Term, 1961

MARK E. SCHLUDE AND MAEZALIE SCHLUDE,  
Husband and Wife, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE.

On Petition to Review Decision of The Tax Court  
of the the United States

This cause came on to be heard on the Petition to Review the Decisions of the Tax Court of the United States entered November 23, 1959 (Tax Court Docket Nos. 69591, 69592 and 69593), determining that there are deficiencies in the income taxes of the Petitioners for the years 1952, 1953 and 1954, after remand by the Supreme Court of the United States for further consideration in the light of its decision in *American Automobile Association v. United States*, 361 U.S. 687, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the Opinion of this Court heretofore filed October 19, 1960, be withdrawn, and the judgment entered therein is hereby vacated, set aside and held for naught.

It is further Ordered and Adjudged by this Court that the decisions of the Tax Court of the United States be and they are hereby, affirmed.

And it is further Ordered and Adjudged by this Court that the petition to review in this cause be, and the same is hereby, dismissed.

December 15, 1961.



## APPENDIX D

## Internal Revenue Code of 1939:

## SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service \* \* \*, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. \* \* \*

(26 U.S.C. 1952 ed., Sec. 22.)

## SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; \* \* \* and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(26 U.S.C. 1952 ed., Sec. 23.)

# SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer, but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

# SEC. 42[A]s amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. \* \* \*

(26 U.S.C. 1952 ed., Sec. 42.)

# SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the

taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. \* \* \*

(26 U.S.C. 1952 ed., Sec. 43.)

Sections 61, 162, 446(a), (b) and (c), 451 and 461 of the Internal Revenue Code of 1954, applicable to the year 1954, correspond to the sections of the 1939 Code set out above. Treasury Regulations 148, promulgated under the Internal Revenue Code of 1939:

Sec. 39.41-1. *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

Sec. 39.41-2. *Bases of computation and changes in accounting methods.* (a) Approved standard methods

of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred."

All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him with restriction. (See §§ 39.42-2 and 39.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 39.22(c)-5.)

**Sec. 39.41-3. *Methods of Accounting.*** It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income . . .

**Sec. 39.42-1. *When included in gross income.***—(a) *In general.*—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as

of a different period in accordance with the approved method of accounting followed by him. See §§ 39.41-1 to 39.41-3, inclusive. \* \* \*

Sec. 39.43-1. *"Paid or incurred"* and *"paid or accrued."* (a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See Section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

Sec. 39.43-2. *When charges deductible.* Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct

return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a growing business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. \* \* \*

Sections 1441-1445 to (c), 1446-1449 to (c) and 1451-1454, Treasury Regulations on Income Tax (1954 Code), are in material respects substantially the same as the sections set out above.



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Supreme Court of the United States

BRIEF AMICUS CURIAE OF AMERICAN INSTITUTE  
OF CERTIFIED PUBLIC ACCOUNTANTS IN SUPPORT  
OF PETITION FOR WRIT OF CERTIORARI TO  
THE UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

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IN THE  
**Supreme Court of the United States**  
OCTOBER TERM, 1961

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No. 793

MARK E. SCHLUDE and MARZALIE SCHLUDE

COMMISSIONER OF INTERNAL REVENUE

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**BRIEF AMICUS CURIAE OF AMERICAN INSTITUTE  
OF CERTIFIED PUBLIC ACCOUNTANTS IN SUPPORT  
OF PETITION FOR WRIT OF CERTIORARI TO  
THE UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT**

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**STATEMENT OF INTEREST OF THE INSTITUTE**

The American Institute of Certified Public Accountants is a nation-wide professional organization of more than 42,500 certified public accountants out of a total of approximately 70,900 in the United States. It is a non-profit organization chartered under the laws of the District of Columbia, and is the only national professional organization of certified public accountants. Its membership embraces certified public accountants from every state and territory, and from the District of Columbia and Puerto Rico.

The Institute and its members have a profound interest in maintaining a proper relationship between accepted accounting principles and accounting for tax purposes. They believe the Petition should be granted because the Court of Appeals for the Eighth Circuit has erroneously construed and applied this Court's decision in the *American Automobile* case in a manner that will have a far-reaching and adverse impact upon many taxpayers who report income on an accrual basis. Review of the decision in the *Schlude* case, the Institute believes, is of importance to assure the proper administration of the federal income tax laws and to avoid unnecessary confusion, uncertainty and litigation that may otherwise develop in the field of tax accounting by accrual basis taxpayers. The Institute, accordingly, submits this brief *amicus curiae* in support of the Petition for a Writ of Certiorari in the *Schlude* case and urges that the Writ be granted for the reasons set forth below.

The consent of the parties to the filing of this brief *amicus curiae* has been filed with the Clerk of the Court.

#### **OPINIONS BELOW, JURISDICTION AND STATUTES INVOLVED**

The Institute respectfully refers the Court to the Petition of the taxpayers for the Statement of the Opinions Below, Jurisdiction and Statutes Involved.

#### **QUESTION PRESENTED**

The question presented is: When an accrual basis taxpayer's method of accounting accurately matches revenues derived from services performed in the tax year with related costs, does the decision in *American Automobile Association v. United States*, 367 U.S. 687,

authorize the Commissioner to tax as income the entire face value of long term executory service contracts in the year such contracts are signed although a large portion of amounts received under the contracts has not yet been earned and an even larger portion of the face value of the contracts has been neither received nor earned?

### STATEMENT

Petitioners operated a partnership that provided dance instruction services. The students paid a portion of the face value of contracts entered into with the partnership when the contracts were signed and promised to pay the remainder thereafter in installments (R. 108-111, 121-122, 207).<sup>1</sup> The contracts giving rise to the income here in question ran for a term greater than an annual tax year (R. 145, 208). Although the contracts bound the partnership to perform the required services, the dates for each hour of instruction were not scheduled in the contracts but were agreed to from time to time with the student as individual lessons were given (R. 186-187, 207-208). Each contract, how-

<sup>1</sup>Under some contracts a student made all subsequent payments directly to the partnership. Under another type of contract the student made a part of the subsequent payments to the partnership and another part, evidenced by the student's negotiable note, to a bank to which the partnership had transferred the note. Upon such transfer, the bank deducted interest charges, paid approximately 50 percent of the balance of the note to the partnership and retained the remainder in a reserve account which the partnership could not draw upon until the student had paid the note in full (R. 108-111, 122-123, 208).

"R." references are to the record before the Court of Appeals below on appeal from the decision of the Tax Court, a copy of which was filed in this Court on March 15, 1962, together with the Petition for a Writ of Certiorari.



ever, provided a period certain before the expiration of which all the hours of instruction contracted for were required to be taken, and the partnership followed the practice of cancelling any contract under which no instruction had been requested by a student for one year (R. 108-111, 154, 210).

Although each contract contained a clause prohibiting the student from cancelling the contract and thereby avoiding payments thereunder, in fact almost 20 percent of the contracts were cancelled in the tax years 1952, 1953 and 1954—the years here in issue (R. 197, 215). The partnership, moreover, was frequently compelled to reduce the hours of instruction—and, accordingly, the payments due—under other contracts in order to avoid cancellations (R. 153, 208).

The partnership has always used an accrual method of accounting that had been designed by a certified public accounting firm to match the partnership's revenues derived from services rendered under each contract in the tax year with costs of performing such services. As each contract was signed, the total contract price was credited to a "deferred income" account. Individual student record cards were maintained that identified each student, the type of contract, hours involved, total contract price, and the hours of instruction given and payments made under the contract. At the end of the partnership's tax year, the card for each student was reviewed, and the amount of income earned under each contract was determined by multiplying the number of hours of instruction given by the rate per hour on that contract. The "deferred income" account was then reduced by that

amount and an "earned income" account increased by the same amount. Earned income from all contracts was totalled and was reported as income on an accrual basis in the partnership's tax return for that year (R. 146-149, 200-214).<sup>2</sup>

Contending that the entire face amount of each contract constituted income to the partnership in the year the contract was signed, the Commissioner rejected the partnership's accounting system for tax purposes and instead increased the net income of the partnership for each of the tax years 1952, 1953 and 1954 by some \$24,000, \$405,000 and \$13,000—the total increase in the "deferred income" account for each such year (R. 213-215). On this basis, he determined deficiencies against the taxpayers for these years of some \$18,000, \$83,000 and \$11,500, respectively (R. 204). The Tax Court, three judges dissenting, sustained the Commissioner's ruling. It held that the entire face value of each contract was income in the year it was signed, although in that year a large portion of payments made by the student was as yet unearned by performance and an even larger portion of the face value of the contract remained both unpaid and unearned (R. 215).

The Court of Appeals for the Eighth Circuit reversed and held that the accrual accounting system used by the partnership was "eminently designed to reflect true income" (Pet. App. B, p. 13a). This Court thereafter granted a Writ of Certiorari, vacated the judgment of the Court of Appeals and remanded the case to that court "for further consideration in light

<sup>2</sup>Any gain arising from the cancellation of a contract by a student or by the partnership (where no instruction had been given for a year) was also reported as income on the tax return (R. 153-154, 210).

of *American Automobile Association v. United States*, [367 U.S. 687]. See 367 U.S. 911 and 368 U.S. 873. On December 15, 1961, the Court of Appeals rendered a *per curiam* opinion affirming the decision of the Tax Court. Citing nothing more than the *American Automobile* decision, the court stated: "In light of that case we have carefully examined and considered petitioners' method of accrual accounting and are convinced that such method does not, for income tax purposes, clearly reflect income" (Pet. App. A, p. 24).

#### **REASONS WHY THE INSTITUTE BELIEVES THE WRIT SHOULD BE GRANTED**

THE DECISION BELOW SERIOUSLY MISINTERPRETS THIS  
COURT'S *AMERICAN AUTOMOBILE* DECISION

The decision below represents a wholly unwarranted departure from this Court's decision in *American Automobile Association v. United States*, 367 U.S. 687. There this Court sustained the Commissioner's authority to reject for income tax purposes an accrual accounting system which, the Court ruled, deferred the reporting of income to subsequent years without precise regard to expenses incurred by the taxpayer in exchange for receipts paid to it. In the *Schlude* case, the court below, relying solely on the *American Automobile* decision, upheld the Commissioner's rejection of what the Institute believes to be a most accurate accrual accounting system that precisely matched revenues derived from services performed in the tax year with the cost of performing such services. Further, and certainly more important from the taxpayers' point of view, *American Automobile* involved the taxation only of advance receipts; it did not tax unreceived and unearned income. Nevertheless, that decision was applied in *Schlude* to tax the entire contract price of

long term executory service contracts as current income in the year such contracts are signed even though the taxpayer can neither receive nor earn the contract price except by performing services in subsequent tax years. These rulings, which constitute the holding below, conflict with established accounting principles and with the law of the *American Automobile* decision.

- A. THE COURT BELOW IMPROPERLY HELD THAT THE *AMERICAN AUTOMOBILE* DECISION DOES NOT PERMIT THE USE FOR TAX PURPOSES OF ACCOUNTING PROCEDURES THAT ACCURATELY MATCH INDIVIDUAL ITEMS OF REVENUE WITH COSTS AS AGREED.

1. The court below has interpreted this Court's decision in the *American Automobile* case to mean that established procedures of accrual accounting, which accurately and precisely match revenues derived from services performed, in the tax year with related items of cost, may no longer be used by accrual basis taxpayers for income tax accounting purposes. The Institute believe that this sweeping result is contrary to the decision in the *American Automobile* case.

The error committed below had its beginning in the court's failure to recognize the substantial and significant distinctions that exist between the system of accrual accounting in the *American Automobile* case and that here involved. The taxpayers in *Schlud* had consistently, since the inception of their business, relied upon accepted accounting principles to report as income for federal tax purposes amounts which the taxpayers had actually earned in performing the services under their contracts. There was recorded on a card for each student the number of hours of instruction given to him in each tax year. Income reported under each contract was determined by mul-

tipling the hours of instruction given by the hourly rate applicable to such contract. The income was thus reported in each tax year precisely to the extent it was earned by the partnership in fulfilling its contract with each student that year, as reflected in these records (R. 146-149, 209-214).<sup>3</sup> This accomplished an appropriate matching of revenues and costs since costs were incurred in the period in which the services were rendered.

In the *American Automobile* case the taxpayer was unable to rely upon a comparably precise and detailed method of ascribing membership dues it received from individual members, all of which the members paid in advance, to the period when actual costs of performing its services were incurred. The accounting system there required only that a ratable portion of these total advance receipts be reported as income for tax purposes on a month-by-month basis over the membership period, without regard to the actual cost of services rendered to each member. 367 U.S. at pp. 688, 690. For this reason, the Court considered the *American Automobile* case controlled in essential respects by *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 189, which upheld the Commissioner's rejection for income tax purposes of substantially the same accrual accounting system because recording the accrual of the membership dues paid to the tax-

<sup>3</sup> All revenue received or receivable was reported in the appropriate tax year, and there was thus no avoidance of taxable income by the taxpayers. The taxpayers' established accounting practice was also to report as income all cash amounts received greater than income earned by performance on contracts that were cancelled by students or contracts under which no instruction had been given for one year (R. 153-154, 210). Further, each contract required that all the lessons thereunder be taken in a time certain (R. 108-111).

payer "in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the members."

From an accounting point of view, therefore, both the *Michigan* and *American Automobile* cases turn on the fact that in recording the accrual of income for tax purposes in any year neither taxpayer could point to the portion of the membership dues that related to the expense of rendering services to individual members. They found it necessary to employ "statistical computations" reflecting the over-all estimated cost of services to all members on a group basis. This deficiency was deemed crucial by the Court in *American Automobile*. Thus, the Court characterized the accrual accounting system there used as one which caused earned income to be reported over the membership period "without regard to correspondingly fixed individual expense or performance justification" and which was not keyed to "the actual incidence of cost in serving an individual member" or "in fact related to the expenses incurred." 367 U.S. at pp. 692-693.<sup>1</sup> In the *Schlude* case the taxpayers achieved exactly what the Court found was lacking in the automobile decisions.

The Institute urges that the *Schlude* petition be considered with the knowledge that the accrual accounting system there used accurately and precisely reflected income as earned—as it accrued to these taxpayers. The taxpayers reported as income those receipts that were

<sup>1</sup> Reliance by the taxpayer upon over-all averages in accruing deductions for claims lodged against it also distinguishes the decision on remand in *Milwaukee & Suburban Transport Co. v. Commissioner*, 293 F. 2d 628 (7th Cir. 1961 *cert. denied*, 37 L. Ed. 2d 438 (January 22, 1962)). See pp. 24 of the Memorandum for the Respondent in opposition to the Petition for Certiorari filed by the taxpayer in the *Milwaukee* case, No. 603, October Term, 1961.



exactly allocable to the "services . . . rendered"; they reported as much income as had been earned "through the fulfillment of [their] required performances" under each service contract. See *Tax Accounting and Generally Accepted Accounting Principles*, Committee on Accounting Principles for Income Tax Purposes of the American Institute of Certified Public Accountants, pp. 6-7 (1953). See also *Accountants' Handbook*, § 20, p. 8 (4th ed. 1956); Paton, W.A., "Deferred Income"—A Misnomer," J. Accountancy, p. 39 (Sept. 1961).<sup>5</sup> (The pertinent text of these authorities is set forth in the Appendix.)

The accounting procedures used in *Schlade* leave open only one conceivable objection of the many that have heretofore been made by the Commissioner. That relates to the claim that the long-term contracts did not definitely schedule the performance of services by the taxpayers in the tax years subsequent to the year a contract was signed. However, while no schedule was

<sup>5</sup> The concern of the accounting profession is, of course, that business and other taxpayers use accounting procedures which reflect their true income, not only for tax purposes but for commercial, regulatory or personal needs, as the case may be. It is, therefore, as significant to the accountant that there be no over-statement of income as it is that there be no understatement of income. In *Matter of C. Cecil Bryant*, 15 S.E.C. 400, 402 (1947), the Commission permanently disqualified a certified public accountant from practice before it on grounds among which was:

"The financial statements covered by the aforesaid certificate contained material misstatements and misrepresentations. For example, accounts receivable shown as 'not yet due' (representing the corporation's principal asset) were found to comprise items for the most part due or past due. In addition, substantial payments received by the corporation for services to be performed in future years were credited in their entirety to income when received, and the result was an overstatement of the income and surplus of the corporation."

set forth in the contracts, as each lesson was given the next lesson was scheduled (R. 186-187). In any event, the Institute believes that this factor alone should not be sufficient to determine whether the Commissioner shall be permitted to reject an accrual accounting system that satisfies accepted accounting principles in every respect and at the same time gives rise to no loss of federal revenues. To give dominance to this single and fortuitous aspect of any business, despite the fact that it is wholly insignificant from the standpoint of protecting the revenues, is not required by the Internal Revenue Codes of 1939 or 1954, or by decisions of this Court. Nor can it be justified by reason or common sense.

The Institute, as an *amicus curiae*, therefore urges the Court to review the decision below so that accrual taxpayers may be apprised as to whether the *American Automobile* decision permits accrual accounting of advance receipts to be used for tax purposes where income is reported precisely and accurately as it is earned.

2. Putting to one side the need for review of the rejection of the precise and accurate accrual accounting system used in *Schlude*, the enactment and subsequent repeal by Congress of Sections 452 and 462 of the Internal Revenue Code of 1954 supply no support for the Commissioner's action. Despite the Court's reliance upon the legislative history of these Code sections dealing with prepaid income and reserves for estimated expenses, the Court's full consideration of the particular accrual accounting system at issue in *American Automobile* indicates that the Court's *holding* was only that the action of the Commissioner in rejecting that accounting system as inadequate was not unsound.

No other conclusion can be reached if the Court's lengthy review of the specific accounting system of the taxpayer in that case is not to be deemed superfluous. The Court's reliance upon the legislative history of the 1954 Code provisions, on the other hand, may be properly understood as a persuasive but not controlling ground upon which it upheld the Commissioner's rejection of the accrual accounting system in *American Automobile*.<sup>6</sup>

Moreover, whatever effect the Court intended to give to the legislative history of Sections 452 and 462, that effect should now be viewed in light of two subsequent developments in the area of accrual accounting for tax purposes. These developments are: first, the statements of committees of Congress in reports accompanying the enactment on July 26, 1961, of a new Section 456 in the 1954 Code which strongly suggests that in repealing Sections 452 and 462 in 1955, Congress did not intend to prohibit the use of all accrual accounting systems for advance receipts without regard to how accurately and precisely any such system

<sup>6</sup> Even if the Court's reference to the legislative history of Sections 452 and 462 constituted an alternative holding in the *American Automobile* case, this portion of the opinion should be construed as a reading of that legislative history only as it applies to the type of accrual accounting system used by the taxpayer in that case, in which over-all estimates and averages of costs and expenses are relied upon to determine reportable income. In discussing the legislative history, the opinion frequently referred to the effect of the legislative history upon "the [accounting] practice as was used by the [Automobile] Association here" and upon "the method used by the Association." 367 U.S. at pp. 694-95. The Court also referred to repeated unsuccessful attempts by the taxpayer in *American Automobile* to convince Congress to pass legislation which, in terms, would have authorized such taxpayers to use the very same type of accrual accounting system that was being reviewed by the court. *Id.* at p. 696.

actually reflected earned income?" and *second*, the recent issuance by the Commissioner of Internal Revenue of regulations under Section 455, enacted in 1958 to govern taxation of income received in advance for newspaper and periodical subscriptions, which explicitly recognize that taxpayers who had previously been deferring the recognition of taxable income from such sources "under an established accounting method" may continue to do so without regard to the specific provisions of Section 455 itself or of the new regulations thereunder.<sup>7</sup> The Commissioner's regulations on Section 455 and the committee reports accompanying the new Section 456 appear to acknowledge that the use

<sup>7</sup> New Section 456 allows membership organizations such as the taxpayer in *American Automobile* to report income over an accrual period greater than an annual tax accounting year as it is earned in performing the services for which their members pay dues. The congressional reports state that "Congress recognized in the committee reports" accompanying the bills repealing Sections 452 and 462 in 1955 "the desirability of following generally accepted accounting principles for reporting income for tax purposes," and that the two sections were repealed because "Congress became aware of the fact that a large revenue loss was involved" in the "first years of [their] application." H.R. Rep. No. 381, 87th Cong., 1st Sess., p. 2 (1961); S. Rep. No. 543, 87th Cong., 1st Sess., p. 2 (1961).

<sup>8</sup> Regulations § 1.455-5(d) reads:

"Treatment of prepaid subscriptions income under an established accounting method. Notwithstanding the provisions of section 455 and § 1.455-1, any taxpayer who, for taxable years beginning before January 1, 1958, has reported prepaid subscription income for income tax purposes under an established and consistent method or practice of deferring such income may continue to report such income in accordance with such method or practice for all subsequent taxable years to which section 455 applies without making an election under section 455." (Promulgated as Treasury Decision 6591, February 23, 1962.)

of accrual accounting methods was permissible for tax purposes before the enactment of Sections 452 and 462 and was not affected by their repeal in 1955.

(B) THE COURT BELOW MISAPPLIED THE *AMERICAN AUTOMOBILE* DECISION IN HOLDING SUBJECT TO TAX PORTIONS OF THE FACE VALUE OF SERVICE CONTRACTS WHICH HAD BEEN NEITHER RECEIVED NOR EARNED.

What has been said so far has had to do with the Institute's professional concern over the mischief that the *Schlude* decision does to the use of precise and accurate accepted methods of accounting for tax purposes. The error committed below is made even more graphic when one considers that the court also found the *American Automobile* decision to be authority for a proposition with which that decision did not even purport to deal, i.e., that the *unearned future contract receipts* of an accrual basis taxpayer are taxable in the year the contract is signed.

The *Schlude* taxpayers' business was conducted to a very large extent on the basis of executory service contracts under which a student made a down payment and promised to make future payments during the life of the contract, which extended into subsequent tax years (R. 122-123, 148, 208). This situation is essentially the reverse of that in *American Automobile*, where the business was conducted on the basis of amounts actually prepaid by customers. 367 U.S. at p. 690. Nevertheless, the court below, relying entirely on *American Automobile*, affirmed the Commissioner's determination that the entire contract price of each contract was to be reported as income by the taxpayers in the tax year in which the contract was entered into, including that part of the price representing payments to be made in subsequent years.

The court below thus wholly disregarded a fundamental distinction between accrual taxpayers who have received advance receipts, on the one hand, and such taxpayers whose performance and receipts are postponed to subsequent tax years, on the other. The result was a misapplication of the *American Automobile* ruling in a further respect that will be of far greater impact upon accrual basis taxpayers than any decision affecting tax accounting for advance receipts alone.

1. Wholly apart from any question of the adequacy under accounting principles of accounting methods used by accrual taxpayers such as *Schlade*, the *American Automobile* decision can not be read to authorize the Commissioner to require the reporting as income under long-term service contracts of the entire contract price in the year in which the contract is signed. Nothing in the *American Automobile* decision sustains such a result. The taxpayer there always received in advance funds paid by its members as dues and in return for which the taxpayer became obligated to perform services. These funds were immediately available to the taxpayer for its unrestricted use.

In the *Schlade* case, not only were many payments under the service contracts to be made in subsequent years, but, the record discloses, there was no assurance whatsoever that such subsequent payments would in fact be made. A large number—almost 20 per cent.—of the service contracts were cancelled or defaulted by the students; others of the contracts were required to be rewritten for a smaller number of lessons than had been contracted for initially, in order to persuade students not to cancel or default entirely on the contracts (R. 153, 197). And, the cancellations and defaults took place, and the rewriting of contracts for



shorter periods was necessary, even though each contract contained a clause providing that it was non-cancellable (R. 108-111). In these circumstances, it is apparent that the taxpayers could by no means expect that they would ever receive the unpaid portion of a long-term contract signed by a student.

The only case cited to the court below by the Commissioner in support of his action was *Commissioner v. Hansen*, 360 U.S. 446.<sup>9</sup> *Hansen* is, however, inapposite here since the accounting method used by the taxpayers in the *Schlude* case for unpaid portions of the service contracts did not result in deferring the recognition of income which those taxpayers had a "fixed right to receive," as was the case in *Hansen*. *Id.* at p. 464.

In *Hansen* the accrual basis taxpayers had fully performed their obligations under contracts with customers—by delivery of vehicles that had been sold—and had accordingly earned all of the contract price. See *id.* at p. 448. For this reason it was of no significance for tax purposes that a part of the contract price was being held in reserve accounts for the taxpayers by their financing organizations and would not be paid to them in cash until subsequent tax years. The amounts held in reserve had been as much earned by those taxpayers as the amounts actually paid in cash to them as down payments by car buyers and the amounts paid by the financing organizations, to whom the taxpayers sold the negotiable notes of the car buyers for the balance of the contract price. In *Schlude*, on the other hand, substantial portions of the contract remained not only unpaid when signed, but

<sup>9</sup> Supplemental Memorandum for the Respondent on Remand to the Court of Appeals in *Schlude v. Commissioner* (pp. 6-8).

also remained unearned by the taxpayers until they performed the services the contracts called for.<sup>10</sup> Simply stated, the unpaid amounts were amounts which the *Schlude* taxpayers would have a "fixed right to receive" only as they performed services.

Not only may no support be gleaned from the *Hansen* and *American Automobile* decisions for this aspect of the decision below, but as a matter of simple justice it cannot be that the entire unpaid and unearned portion of the face value of a service contract for a term of years may be taxed as income in the year the contract is signed. Such a result is improper and arbitrary; it has no more justification than would the taxation of all future interest coupons on a bond, or of all future unpaid rental under a lease, in the year in which the bond is purchased or the property leased.

2. The improper extension of this Court's *American Automobile* decision by the court below to amounts not yet received would be remedied if this Court were to decide that the *Schlude* taxpayers' accrual accounting system was proper for tax purposes under *American Automobile*.

<sup>10</sup> It would, of course, be equally improper to equate the situations of the taxpayers in the *Hansen* and *Schlude* cases merely because in both proceedings the taxpayers discounted with financing organizations all or part of long-term contracts on which amounts remained unpaid. See p. 3 n. 1 above. The fact that in both cases the financing organizations withheld a portion of the discounted value of the contract in a "reserve account" should be no more determinative of when the *Schlude* taxpayers received reportable income than is the fact that the bank actually paid them 50 percent of the unpaid portion of the contract in cash immediately. The test in each instance should be: what portion of the cash payments or of the reserve accounts—like payments made by students to the taxpayers directly—was earned in any tax year.

The taxpayers' accounting method in *Schlude* was as accurate in determining income in a tax year for the unpaid portions of the service contracts as it was for the portions as to which the taxpayers received advance receipts. Under the accounting procedures that were followed, the taxpayers simply reported all income precisely as it was earned under each contract through their performance of services in each tax year, without regard to whether cash amounts allocable to the taxpayers' performance might or might not have in fact been paid by a student. It was thus possible that the taxpayers would have reported income under a long-term contract as to which they had performed more services than they had actually been paid for in cash. This result, of course, is proper under accrual accounting, and can not be objected to by accrual basis taxpayers, for the reason that income in such a case has been "earned"—that is, properly accrued—by the taxpayer. See, e.g., *Continental Tie & L. Co. v. United States*, 286 U.S. 290, 295-296; *Beacon Publishing Co. v. Commissioner of Internal Revenue*, 218 F. 2d 697, 699 (10th Cir. 1955). The *Schlude* taxpayers' objection, therefore, and the concern of the Institute, is not merely that there should be no taxation of unpaid portions of contracts in the year the contract is signed because the taxpayers have received no cash amounts as to such unpaid portions, but more importantly, that the unpaid portions of contracts should not be taxed until the time the taxpayers' performance of services earns income.

3. The construction of the *American Automobile* decision by the court below will have a severe impact upon all accrual basis taxpayers who agree to perform services or produce goods in the future in return for a buyer's promise to pay. There is no satisfactory basis

upon which that construction may be narrowed to the facts of the *Schlude* case. "The decision of the Tax Court, which became in effect the decision of the Court of Appeals, was that the 'fixed and unconditional right of the studio to receive' the full price of a long-term contract arose at the time the contract was entered into (R. 215). The Tax Court's ruling in respect of the unpaid portions of the contracts, therefore, did not rely upon such considerations as the accuracy of the taxpayers' accounting system, the fact that the services the taxpayers were to perform in subsequent years were not scheduled for fixed times, or any other factors that were treated in this Court's *American Automobile* decision. Accordingly, because this aspect of the *Schlude* ruling necessarily will have broad application in the future to a variety of different business and accounting contexts, the Court should review the decision and determine whether it shall continue to govern the tax accounting practices of the many accrual basis taxpayers whom it affects.

#### CONCLUSION

For the foregoing reasons, the Institute urges that the Petition for a Writ of Certiorari in *Schlude v. Commissioner* be granted.

Respectfully submitted,

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March 19, 1962.

## APPENDIX

## Pertinent Text From Accounting Authorities

*Tax Accounting and Generally Accepted Accounting Principles*, Committee on Accounting Principles for Income Tax Purposes of the American Institute of Certified Public Accountants, pp. 6-7 (1953):

"The process of matching or properly assigning revenues and expenses to an accounting period involves recognition of revenue which has been earned but has not yet been received and of expense which has been incurred but has not yet been paid; it involves the deferring or carrying forward as a charge against the future of some expenditures which have been incurred or paid, and the deferring or carrying forward to future periods of certain revenues which have been received.

"The fundamental generally accepted accounting principles which govern the treatment of revenues, costs and expenses falling within the areas of divergence under consideration may be stated briefly as follows:

"1. Revenues are recognized as entering into the determination of income when sales are made or services are rendered.

"2. The mere receipt of money or promise of another person to pay money for goods or services does not represent revenue which should be recognized in the determination of income of the period of receipt if it is burdened with an obligation to deliver goods or render services in the future. Items of this nature are treated as resulting in liabilities or deferred credits until they are earned through the fulfillment of the required performances. However, the fact that incidental costs or claims are yet to be met does not warrant deferring recognition of revenues; for example, revenues from sales are recognized despite the fact that they are subject to product guarantees or sales allowances. These incidental costs and allowances are deemed to be charges of the period in which the revenues are taken into income."

*Accountants' Handbook*, § 20, p. 8 (4th ed. 1956):

"DEFERRED REVENUES. Advances by customers or clients which are to be satisfied by the future delivery of goods or performance of service are liabilities and should be shown as such. These items have often been labeled 'deferred revenues' or 'deferred credits,' and occasionally are classified on the equities side of the balance sheet between liabilities and proprietorship. Such titles are inclined to be misleading, and such classification is unwarranted. The essential peculiarity of such accounts lies in the fact that they are payable in goods or services rather than in cash, and that as a rule a margin of profit will emerge in making such payment. Under no circumstances should these items be offset against outstanding receivables; nor should they be recorded as earned income prior to delivery of goods or rendering the service for which advance payment has been received."

Paton, W. A., "*Deferred Income*—A Misnomer,"  
J. Accountancy, p. 39 (Sept. 1961):

"If there is a major point upon which there is general agreement in accounting it is that revenue results from the over-all process of production, and not from borrowing or otherwise raising funds. Moreover, for most lines of business, revenue is regarded as recognizable when product is delivered to the customer. It is also axiomatic that net income, if any, is the amount by which total revenue for the period, represented by the sale value of the delivered product, exceeds all the expenses, losses, and taxes properly applicable to such total revenue. In the face of these basic considerations how can we justify using the word 'income,' even with the qualifying term 'deferred' attached, to describe the amount of a customer advance? Such an advance may be received before the process of production has even been started; before any costs have been incurred, and before anyone knows for certain that any 'income' will ever be realized on the particular operation or contract!"



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UNITED STATES DISTRICT COURT

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# In the Supreme Court of the United States

OCTOBER TERM, 1961

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No. 793

MARK E. SCHLUDE AND MARZALIE SCHLUDE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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### PRIOR OPINIONS

The findings of fact and opinion of the Tax Court (R. 203-221) are reported at 32 T.C. 1271. The first opinion of the Court of Appeals (Pet. 2a-16a) is reported at 283 F. 2d 234. The *per curiam* decision of this Court granting certiorari and remanding the case is reported at 367 U.S. 911. The order of this Court denying rehearing and amending the previous *per curiam* order is reported at 368 U.S. 873. The *per curiam* opinion of the Court of Appeals upon remand (Pet. 1a-2a) is reported at 296 F. 2d 721.

**JURISDICTION**

The judgment of the Court of Appeals was entered on December 15, 1961. (Pet. 17a.) The petition for a writ of certiorari was filed on March 15, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

**QUESTIONS PRESENTED**

1. Whether an accrual-basis taxpayer who contracts to provide a stated number of dancing lessons during a period extending beyond the close of the taxable year is required to accrue as income cash and negotiable notes received as an advance payment of the contract price.

2. Whether such a taxpayer is required to accrue as income future installments unconditionally due under the contract whether or not any lessons have been taken.

**STATEMENT**

The taxpayers, husband and wife, formed a partnership in 1946 known as Arthur Murray Dance Studio (the "Studio"), for the purpose of conducting dance studios in territories authorized by various franchise agreements received from Arthur Murray, Inc., of New York City. The partnership operated studios in the States of Nebraska, Iowa and South Dakota, for the purpose of teaching private ballroom dancing to individual students. (R. 205-206; Pet. 3a.)

Basically, there were two kinds of contracts entered into between the partnership and students. Under one type, all of the down payment was made in cash at the time the contract was executed, with the balance

of the tuition or contract price to be paid in deferred installments. Under the other, a portion of the down payment was paid in cash at the time the contract was entered into, and the balance thereof was to be paid in installments; the remainder of the contract price was evidenced by a negotiable note taken from the student, which was payable in designated installments in accordance with its terms. (R. 206-207; Pet. 3a.)

All of the contracts provided (1) that the student would pay tuition for lessons in a certain amount, (2) that the student should not be relieved of his obligation to pay the tuition agreed upon in the contract, (3) that no refunds would be made, and (4) that the contract was noncancellable. The contracts provided for a specific number of hours of lessons ranging from 5 to 1,200. Some of the contracts were for lifetime courses under which, in addition to 1,200 specified hours, the student was entitled to 2 hours of lessons per month plus 2 parties a year for life. The contracts specified a period during which the lessons had to be taken but did not schedule specific dates for the lessons, the dates being arranged from time to time as lessons were given. Under most of the contracts in which lessons extended beyond the fiscal year in which the contract was made, the lessons were given in the next fiscal year. (R. 207-208; Pet. 3a-4a.)

Notes accompanying deferred payment contracts received by the Studio were negotiated with a local bank. At the time a student's note was negotiated



with the bank, the bank would deduct its interest charges, pay approximately 50 per cent of the balance of the note to the partnership, and set up a reserve account for the other 50 per cent of the note which the partnership could not use until after the note was paid in full by the student. After the note was paid, the balance in the reserve account was transferred to the partnership's general bank account. (R. 208; Pet. 4a.)

Cash payments received by the partnership directly from students, the amounts received by the partnership at the time notes were transferred to the bank, and the amounts received by the partnership when notes transferred to the bank were fully paid were either deposited or credited to a partnership general bank account without segregation from other partnership funds. (R. 208.)

Although the contracts stated that they were non-cancellable, the Studio frequently rewrote contracts to reduce the number of lessons and the total charge. Also, despite the fact that the contracts provided that no refund would be made, and despite the fact that the Studio discouraged refunds, occasionally a refund would be made on a canceled contract. (R. 208-209.)

When the partnership was organized in 1946, a complete double entry bookkeeping system was installed for the partnership by a firm of certified public accountants, and an accrual system of accounting, with a fiscal year ending March 31, was employed. This accounting system was used continually and consistently from the time the partnership was formed.

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Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract. (R. 209; Pet. 5a.)

The accounting method used by the partnership is shown in detail in the findings of the Tax Court. In substance, when a contract was entered into with a student, a "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and the number of hours of lessons taught was determined; this figure multiplied by the contract rate per hour, was regarded as the amount of income earned. This amount was then charged to "deferred income" and credited to "earned income." Earned income thus derived was reported as income on the partnership's tax return. Gain resulting from cancellation of a contract was also reported as taxable income in the year of cancellation. Detailed schedules reflecting the partnership's system of accounting during the years in question appear in the findings of fact of the Tax Court. (R. 209-213; Pet. 5a.)

The Commissioner ruled that the entire amount of the contract price represented gross income in the year in which the contract was entered into. (R. 214-215.) Accordingly, in his notices of deficiency he increased the ordinary net income of the partnership for the fiscal years ended March 31, 1952, 1953 and 1954, by

the amounts of the increases in the "deferred income" account in those years, *viz.*, \$24,602.22 for 1952, \$104,798.41 for 1953, and \$12,797.97 for 1954. (R. 213; Pet. 5a-6a.) The Tax Court, three judges dissenting, sustained the Commissioner's determination. (R. 203-221.) The court of appeals, one judge dissenting, reversed the Tax Court. (Pet. 2a-16a.)

The Commissioner's petition for certiorari to review the court of appeals' decision was pending when this Court decided *American Automobile Assn. v. United States*, 367 U.S. 687. Thereafter, the Court granted certiorari, vacated the judgment, and remanded the case to the court of appeals for reconsideration in the light of that decision. 367 U.S. 911; 368 U.S. 873. Upon reconsideration, with full argument, the court of appeals vacated its prior judgment and affirmed the decision of the Tax Court, stating *per curiam* (296 F. 2d 721, 722):

In light of \* \* \* [*American Automobile Assn.*] we have carefully examined and considered petitioners' method of accrual accounting and are convinced that such method does not, for income tax purposes, clearly reflect income.

#### ARGUMENT

1. In the year in which the dance-instruction contracts were made, petitioners received a substantial part of the contract price in cash. The decision below that the amounts thus received in cash must be included in income in the year of receipt and may not be "deferred" until subsequent years was, we submit,

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—required by this Court's decision in *American Automobile Assn. v. United States*, 367 U.S. 687.

In the AAA case, the Association, an accrual-basis taxpayer, was paid in advance membership dues for a 12-month membership period. Claiming that the dues were "earned" evenly over the period during which it was liable to perform services for the members, the Association, following accepted commercial accounting principles, accrued as income only one-twelfth of the dues for each month of membership falling within the taxable year. Rejecting the view that commercially-accepted accounting principles—in particular, the principle that income should not be accrued until "earned"—were determinative for income tax accounting, this Court upheld the Commissioner's rejection of the method of accounting used and required the dues to be included in income in the year received.

Petitioners seek to distinguish the AAA decision on the ground that the services to be performed by the Association for any single member were uncertain and contingent (e.g., road service, contingent upon mechanical breakdowns) whereas the contracts here were for the performance of specific, identified, services (a definite number of dance lessons). It is true that the Court, both in AAA and in the predecessor decision in *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, emphasized the contingent nature of the services as a factor making the method of deferral used "artificial". Additionally, the Court distinguished *Beacon Publishing Co. v. Commissioner*, 218

F. 2d 697 (C.A. 10), and *Schuessler v. Commissioner*, 230 F. 2d 722 (C.A. 5), on the ground that in those cases the taxpayer was required "to furnish services at specified times in years subsequent to the tax year" while, in the case of the automobile clubs, "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year" (353 U.S. at 189, n. 20; 367 U.S. at 691, n. 4). Even assuming, however, that the AAA decision leaves open the validity of such a distinction, this case would fall on the AAA, rather than the *Beacon Publishing*, side of the line. While the contracts were nominally for a stated number of dance lessons to be given within stated time limits, the services were not to be performed, as in *Beacon* and *Schuessler* at "fixed dates" in the future but only as and when demanded by the customer. Nor is that a merely formal distinction, for petitioners' experience has been that a large proportion of the lessons contracted for are never taken, with the result that petitioners' actual performance under any individual contract is in fact uncertain and contingent. While the automobile clubs' per-month method of accrual was at least consistent with their actual group experience, petitioners' per-lesson method of accrual (based on the disproven assumption that all lessons contracted for will be taken) is contradicted by its own experience.

More importantly, however, we do not believe that the AAA decision can be limited, as petitioners would limit it, to cases in which the services to be performed are uncertain. The language upon which petitioner

relies for that distinction is found in the first part of the opinion, the burden of which was to show that the method of accounting used by the Association was subject to the same defect (uncertainty as to the time and nature of performance) as the method condemned in the earlier decision in *Automobile Club of Michigan*, making that decision controlling. As the *amicus curiae* brief seems to recognize, however (see *Amicus* Br. 11-12 and n. 6), the Court's opinion in *AAA* did not rest with reliance on the prior decision in *Michigan*. Pointing to "other considerations requiring our affirmance" independently of the controlling force of *Michigan* (367 U.S. at 694), the Court went on to demonstrate, from the history of the 1954 Code and its amendments dealing with the income-deferral problem, affirmative Congressional endorsement of the view long held by the Commissioner and the courts disallowing the deferral of income for tax purposes. From that demonstration, the Court concluded that it should follow the established administrative and judicial practice barring deferral and leave to Congress the carving out of appropriately limited exceptions, a course made particularly desirable by "the complications inherent in the problem and its seriousness to the general revenue" (367 U.S. at 697). Whatever

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<sup>1</sup> In addition to the extensive legislative activity in this field noted by the Court in the *AAA* opinion (367 U.S. at 694-697), Congress has since that decision added to the Code a specific provision authorizing—with specified limitations and safeguards—automobile clubs and certain other membership organizations to defer prepaid dues income for taxable years beginning after 1960. § 456 of the 1954 Code, added by § 1, Act of July 26, 1961, 75 Stat. 222. That step-by-step approach to a legislative solution (see also the specific provision added in 1958 to



may be said of the implications of the first part of the opinion, there is nothing in the rationale of the latter part by which to confine it to contingent-service contracts. That ground of the decision is equally applicable here and was properly found to be controlling by the lower court.<sup>2</sup>

2. Petitioners alternatively argue that, even if the cash payments must be accrued, the decision below is wrong at least insofar as it requires accrual not only of the portion of the contract price paid in cash but also of the portion due to be paid in installments in the following year.<sup>3</sup> Since the AAA case in fact in-

permit deferral of subscription income, § 455) reflects Congress' caution in dealing with the problem of income deferral after the unexpected revenue loss occasioned by them forced Congress to repeal the original provisions of the 1954 Code generally authorizing the deferral of income and the creation of reserves for anticipated expenses (§§ 452 and 462, the history of which is recounted in the AAA opinion).

<sup>2</sup> The alternative holding of the AAA opinion also precludes any claim of conflict with the few prior decisions of the lower courts permitting income-deferral. Thus, while the *Beacon* and *Schuessler* cases, *supra*, were distinguished by the Court in *Michigan* and in the first part of the AAA opinion, neither their rationale nor their authority can survive this Court's analysis of the significance of the legislative history of income-deferral. Whether or not they were technically "overruled," those decisions are no longer of sufficient viability to establish a conflict. As we have previously noted, those cases are in any event distinguishable on their facts.

<sup>3</sup> In many instances, petitioners received negotiable notes for the unpaid part of the contract price. Petitioners raise no separate question as to the treatment of the notes and impliedly acknowledge that for accrual purposes they stand on the same footing as the amounts paid in cash. Cf. *Commissioner v. Hansen*, 360 U.S. 446; *General Gas Corp. v. Commissioner*, 293 F. 2d 35 (C.A. 5), certiorari denied, 369 U.S. 816; *Shapiro v. Commissioner*, 295 F. 2d 306 (C.A. 9), certiorari denied, 369

volved only actual cash receipts, the Court cannot be said to have passed on this precise question in that case. Nevertheless, the decision below is fully supported by the implications of that decision, and the question is not in any event of sufficient importance to warrant review by this Court in the absence of a conflict.

In urging the importance of the question, both petitioners and the *amicus* brief assume that the decision below requires immediate accrual of the total contract price upon the making of any and all kinds of executory contracts (Pet. 12-13; Amicus Br. 14-19). Were that the implication of the decision, we might well agree that the question was of broad importance and warranted review by this Court. In fact, however, the decision below is confined to the atypical payment provisions of these particular contracts. It does not at all imply, and the government has not contended, that an accrual basis taxpayer must accrue income whenever he signs a contract to perform services.

For accrual accounting purposes, the crucial event is the coming into being of a fixed right to receive payment (or, on the deduction side, a fixed obligation to pay). In most business contracts, the promise to pay and the promise to perform are dependent covenants, and no duty to pay (and hence no right to receive payment) comes into being until after performance. The right to receive payment being conditioned

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U.S. 829; *Morgan v. Commissioner*, 277 F. 2d 152 (C.A. 9); *Wiley v. Commissioner*, 266 F. 2d 48 (C.A. 6), certiorari denied, 361 U.S. 831. The discussion in text is limited to the amounts payable in installments for which no notes were given.

upon performance, there is no unconditional right to payment until performance is completed and hence no basis for accrual of the contract price until then.

In the contracts in this case, however, the promise to pay and the promise to perform are not dependent covenants. There is rather an unqualified promise to pay that is neither conditioned upon performance nor related in time to the dates of performance. The contracts call, in effect, for prepayment of the total contract price but permit deferred installment payments of the balance which the student is unable to pay immediately. Neither the amounts nor the due dates of the installments have any relationship to the number of lessons actually given or expected to be given by those dates, and the payments are unconditionally due even if none of the lessons contracted for have yet been given. While petitioners are independently bound by their undertaking to furnish lessons (and an anticipatory breach of that duty might relieve the student of his duty to complete payment), the furnishing of any particular number of lessons is not a contractual precondition to payment.

In such a case, the conclusion of the court below that the unconditional right to payment must be accrued when it comes into being (*i.e.*, upon the signing of the contract) seems a logical implication of the AAA decision. While that case in fact involved only cash receipts, under accrual accounting principles an actual receipt and an unconditional right to receive are for all purposes equivalent. The significance of

the AAA decision is rather that it rejected the attempt to inject into tax accounting the principle of commercial accounting that income should be accrued when *earned* and reaffirmed the established principle that it is the fixed right to receive or the fixed obligation to pay that is controlling for tax purposes. With the right to payment in this case being fixed and unconditional, and with the date of actual payment being irrelevant for purposes of accrual accounting, the only ground upon which accrual of the income could be postponed is that income should not be accrued until "earned," and it was precisely that principle of accounting that was rejected in the AAA case.

Whatever the merits of the decision below as to the contractual payment rights, however, the issue does not at the present time merit further review by this Court. The AAA case was decided only last Term and there has as yet been little development of its implications in the lower courts. The decision below turns on the seemingly unusual features of the contracts involved, and it has not been demonstrated that the question, thus limited, is of widespread importance. There is no conflict and the decision below is one of first impression in the courts of appeals. Even should the question prove to be of greater importance than it has yet been shown to be, it can profitably be left to further development in the lower courts before further consideration by this Court.

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<sup>1</sup> See, e.g., *Security Mills Co. v. Commissioner*, 321 U.S. 281, 286-287; *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182; *Commissioner v. Hansen*, 360 U.S. 446, 464.

## CONCLUSION

For the reasons stated, the petition for certiorari should be denied.

Respectfully submitted,

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No. 793

IN THE

# Supreme Court of the United States

October Term, 1961

MARK E. SCHULDE and MALCOLM SCHULDE

COMPLAINANTS OF ENJOINED REVENUE

MEMORANDUM AMICUS CURIAE OF  
AMERICAN INSTITUTE OF CERTIFIED  
PUBLIC ACCOUNTANTS

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IN THE  
Supreme Court of the United States

OCTOBER TERM, 1961

No. 793

MARK E. SCHLUDE AND MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

MEMORANDUM AMICUS CURIAE OF  
AMERICAN INSTITUTE OF CERTIFIED  
PUBLIC ACCOUNTANTS

As *amicus curiae*, the Institute submits this brief memorandum to set aright respondent's unsupported and erroneous assertions that the question presented for review is not of widespread importance and that the decision below turned on the "seemingly unusual features of the contracts involved," (Resp. Br., p. 13).

1. Respondent's assertion that the decision below turned on the "unusual features" of the dance instruction contracts is unfounded. The Institute knows of no such unusual features. Moreover, the Institute

requested permission to appear as *amicus* solely because it believed the question to be of widespread importance.

Drawing from the broad experience of its members and the accounting functions they perform for a wide variety of businesses, the Institute respectfully informs the Court that there is simply no merit in the suggestion that the issue presented is not of widespread importance. Contrary to respondent's assertion, contracts comparable to those employed in *Schlude* are commonplace in a wide variety of service industries far removed from dancing.\* They may appear in any field of instruction—music, foreign languages, appliance re-

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\* A sampling of comparable contracts of which the Institute is aware would include those used in connection with the following: Correspondence schools; technical instruction courses such as radio and television repair instruction; investment counseling services; gymnasium facilities; subscriptions to book of car wash certificates; purchase of tax or other legal research services with commitment to keep material therein up-to-date over specified periods; purchase of tickets for theatrical, dramatic or musical performances series; purchase involving series of dinners with accompanying entertainment at selected restaurants; services to be rendered for legal retainer; bookkeeping work to be performed over 3-year period; service of typewriters and other office equipment; purchase of encyclopedia with commitment to furnish supplementary volumes over next 5 or 10 years; purchase of toll road tickets; purchase of series of beauty treatments; purchase involving TV servicing and repair; purchase of flying lessons or driving lessons; purchase of instruction in foreign languages; contracts for taking of family photographs at half-year intervals; contracts to develop film negatives and provide film; premiums paid for health and medical treatment and facilities; contracts to provide telephone answering services; contracts for construction and sale of project homes; contracts to erect prefabricated houses; contracts for building upkeep and maintenance, e.g. window-washing services; contracts for exterminators' services and pest control; man, facturers' service contracts, e.g. service contracts on tabulators and computers or on canning equipment.

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pair, to name but a few. Moreover, such contracts are the rule in other service industries. Typically, they are found where such services as investment counseling, business machine maintenance and building maintenance are provided. Such contracts also play an important role in the sale of goods where payment is made over a period that is unrelated to the time in which the goods are produced and delivered.

Accordingly, there is no ground upon which the decision below may be narrowed so that it will not apply to the contractual relations of other taxpayers in many divergent industry situations such as those to which we have referred above. With the decision below as precedent, it may be anticipated that respondent will seek to compel such taxpayers to accrue income for tax purposes under their executory contracts as the *Schlude* taxpayers have been required to do. Such a result alone, it is abundantly clear, is sufficient to make the decision below one of widespread importance that should be reviewed by this Court.

2. The Institute also believes that respondent's argument of contract law concerning "dependent" and "independent" covenants provides no basis for the charge that the *Schlude* contracts contained "atypical payment provisions" not found in the ordinary executory contract for the performance of services in the future. Relying solely upon what it calls the "seemingly unusual features" of the contracts, respondent acknowledges that it "might well agree that the question was of broad importance and warranted review by this Court" if the decision below required immediate accrual of the contract price upon the making of any contract to perform services in the future. Respondent now, indeed, disclaims, taking the position that "an accrual basis taxpayer must accrue income whenever

he signs a contract to perform services" (Resp. Br., p. 11). Respondent thus appears to agree that if its understanding of the law of contracts is erroneous as it bears upon the *Schlude* contracts, the petition should be granted.

Respondent's reliance upon the distinction between "dependent" and "independent" covenants tells only half the story. Respondent neglects to state that the contract doctrine of "implied conditions" is an essential part of—indeed, if it has not superseded—the rule of dependent and independent covenants. It is true that hundreds of years ago, with the advent of the bilateral contract and influenced by the "consideration" of a promise for a promise, the common law courts were willing to interpret such contracts to hold one party on his promise without regard to the ability of the other party to render performance subsequently on his own promise, even in the extreme case in which the latter had already disabled himself from performance. It was not long, however, before the courts recognized that in order to do justice between the parties to such a contract, and looking to the rights and duties of the parties as a whole, it was essential to read into the agreement an "implied condition" that the party seeking to recover on the other's apparently independent promise must himself be in a position to perform as he had agreed.\* It is today hornbook law, therefore, that a contract providing for payment prior to performance does not give the party who is to perform in the future an unconditional right to receive such payment if he disables himself from performing or attempts to alter the performance required of him.

\* Holmes, *Collected Legal Papers*, (1920) pp. 167, 181.

under the contract. 3A Corbin, *Contracts*, § 654 (1960 ed.); 3 Williston, *Contracts* §§ 812, 830, 860 (1936 ed.); *Restatement, Contracts*, §§ 269-270; Patterson, E. W., *Constructive Conditions in Contracts*, 42 Colum. L. Rev. 903, 914, *et seq.* (1942). Under this rule the sterile inquiry into whether the covenants of a contract are "dependent" or "independent" is of no significance in determining the parties' respective liabilities.

Clearly, therefore, respondent's assertion that the *Schlude* taxpayers had "an unconditional right to receive" payments is without foundation. Under settled law, the *Schlude* taxpayers, as all other similarly situated contracting parties, were required to hold themselves in a position to perform in the manner that they had agreed as a condition to receiving payment. In other words, when respondent characterized the *Schlude* contracts as involving "an unqualified promise to pay that is neither conditioned upon performance nor related in time to the dates of performance" (Resp. Br., p. 12), it described a promise as to which the law imposes a condition: the proffer of performance.

Respectfully submitted,

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May 22, 1962

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JOHN E. DAVIS, CLERK

IN THE  
**Supreme Court of the United States**  
OCTOBER TERM, 1962

\_\_\_\_\_  
No. 70

80

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MARK E. SCHLUDE AND MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

\_\_\_\_\_  
**PETITIONERS' REPLY TO BRIEF FOR THE  
RESPONDENT IN OPPOSITION.**

\_\_\_\_\_  
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IN THE  
**Supreme Court of the United States**  
OCTOBER TERM, 1961

\_\_\_\_\_  
No. 793  
\_\_\_\_\_

MARK F. SCHLUDE AND MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

\_\_\_\_\_  
**PETITIONERS' REPLY TO BRIEF FOR THE  
RESPONDENT IN OPPOSITION**  
\_\_\_\_\_

(1) The Government now states that it does not contend that an accrual basis taxpayer must accrue income whenever he signs a contract to perform services (Brief p. 11). However, it states the taxpayers in the case at bar must accrue, on the date of signing, the face value of contracts. The argument, without citation of authority, is that in the contracts here involved the promises to pay and the promises to perform are not dependent. This argument is contrary to firmly estab-

lished law. *Williston on Contracts, Revised Edition*, Volume 3, Section 812 states:

"Despite the fact that the promises of each party in a bilateral contract may not in form be conditional upon performance by the other of his promise the law now recognizes that in substance parties to an ordinary bilateral contract are not interested in a mere exchange of promises but that normally, their real object is to secure an agreed exchange of reciprocal promised performances. The usual situation, then, is one of mutually dependent promises, and the problem of this chapter is what is the effect of the actual or prospective non-performance of the counter-promise upon the duty of the promisor to go forward with performance of his promise."

If the petitioners in this case were, for any reason, unable to perform their promises, it would be a complete defense to any action by them on the student's promises. *Williston on Contracts*, Section 860, says:

"\* \* \* It may be assumed that if the promises, though more than one on each side, constitute a single contract, there is a general dependency between all the promises on one side and all the promises on the other, that is, all the promised performances on both sides must be regarded as the agreed exchange for each other. Consequently a failure as to a material portion on one side will excuse continued performance on the other."

(2) At pages 10-11 the Government's brief says:

"Since the AAA case in fact involved only actual cash receipts, the Court cannot be said to have passed on this precise question in that case." (Citing *American Automobile Association v. United States*, 367 U.S. 687.)

In the petition for certiorari No. 629, October Term 1960, 367 U.S. 911 and 363 U.S. 873, the Government stated as its first reason for granting the writ that the decision of the Eighth Circuit was in conflict with the Court of Claims decision in the AAA case. In granting certiorari, and remanding the case without hearing, it is assumed that the Court accepted the Government's statement as to conflict with AAA. The Government now admits that the Court in AAA did not pass on the precise question here involved. It is also of interest to note that in its petition for certiorari seeking review of the prior decision of the Court below the Government contended that the problem presented by this case "is of substantial and continuing importance, both to the Government and to taxpayers." (p. 8) The Government now, however, urges that the question is not "of widespread importance" (p. 13).

(3) The Government states at page 8 that petitioners' experience shows a large proportion of the lessons contracted for are never taken, with the result that petitioners' actual performance under any individual contract was uncertain. The brief fails to state that a large proportion of the contract price was never paid or received (R. 166). In other words, the Government's argument is that when a student breached the contract by failing to pay, or failing to take the lessons within the prescribed time, the studio's liability of performance became uncertain. The situation that arises upon a breach of contract by the student is not a fair criterion to conclude that petitioners' obligation to perform under the contracts is uncertain and contingent.

**CONCLUSION**

The rule of *United States v. Anderson* (1926) 269 U.S. 422 sets forth the principle of accrual accounting for all purposes including tax purposes. Since that decision the matching of income against the expenses incurred in earning that income has been universally accepted as the correct method of computing income. Deviation from that method, as in the case at bar, can only result in uncertainty and litigation. This Court should grant the writ and reiterate the rule of *Anderson*.

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May 22, 1962

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IN THE  
**Supreme Court of the United States**  
OCTOBER TERM, 1962

No. 80

MARK E. SCHLUDE and MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

**BRIEF FOR PETITIONERS**

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IN THE  
**Supreme Court of the United States**  
OCTOBER TERM, 1962

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No. 80

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MARK E. SCHLUDE and MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

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**BRIEF FOR PETITIONERS**

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**PRIOR OPINIONS**

The per curiam opinion of the Court of Appeals on remand, dated December 15, 1961, is reported at 296 F. 2d 721, and appears in the record at page 273.

The per curiam order of this Court dated June 19, 1961, granting certiorari and remanding the case, is reported in 367 U.S. 911. Rehearing was denied and the per curiam order amended at 368 U.S. 873.

The prior opinion of the Court of Appeals for the Eighth Circuit dated October 19, 1960, is reported at 283 F. 2d 234, and appears in the record at page 278.

The Findings of Fact and Opinion of the Tax Court of the United States are reported in 32 T.C. 1271 and appear in the record at pages 203-221.

## JURISDICTION

The judgment of the Court of Appeals was entered December 15, 1961. (R. 274) The petition for writ of certiorari was filed March 15, 1962, and was granted May 28, 1962. The jurisdiction of this Court is invoked under 28 U.S.C.A. § 1254.

## STATUTES AND REGULATIONS INVOLVED

The statutes involved are Section 22(a), 23(a)(1) (A), 41, 42 and 43 of the Internal Revenue Code of 1939; Sections 445(a), (b) and (c), 451(a) and 461(a) of the Internal Revenue Code of 1954. See Appendix, *infra*, pp. 1a-4a.

The Regulations involved are Treasury Regulations 118 (1939 Code), Sections 39.41-1, 39.41-2, 39.41-3, 39.42-1, 39.43-1 and 39.43-2; Treasury Regulations on Income Taxes (1954 Code), Sections 1.445-1(a), (b) and (c) in part and 1.451-1(a). See Appendix, *infra*, pp. 4a-10a.

## QUESTION PRESENTED

Petitioners, as partners, operate local dance studios in Nebraska, Iowa and South Dakota. The partnership keeps its books on the accrual method of accounting. It enters into contracts for the giving of dancing lessons with students which in most instances provides that the tuition fee is payable in installments. The partnership reports as income each year that portion of the contract price which represents lessons taught or the liability under the contracts that are cancelled during the year. The Commissioner of Internal Revenue determined that the partnership must report as income the entire contract price at the time the contract is signed, regardless of whether the installment payments

were earned, received, due or payable during the taxable year. The Tax Court sustained the Commissioner and determined that the partnership had to take into income the entire contract price in the year the contract was entered into.

The question for decision is: Is income realized by the signing of an executory contract for the giving of dancing lessons, although a large portion of the amount received under the contract has not yet been earned, and another large portion of the face amount of the contract has not been received nor earned?

### STATEMENT

There appears to be no dispute as to the facts and they may be summarized as follows:

Taxpayers, husband and wife, on June 18, 1946, formed a partnership known as Arthur Murray Dance Studio for the purpose of conducting and operating dance studios authorized by certain franchise agreements entered into with Arthur Murray, Inc., of New York City. The venture was carried into effect and the partnership operated studios in the States of Nebraska, Iowa and South Dakota, for the specific purpose of teaching private ballroom dancing to individual students. (R. 248-249)

There were two kinds of contracts entered into between the partnership and students desiring dancing instructions. Under one type, a portion of the total tuition was paid in cash when the contract was signed, and the balance paid subsequently in installments. Under the other, a portion of the down payment was paid in cash at the time the contract was entered into, and the balance of the down payment was to be paid in

installments, the remainder of the contract price being evidenced by a negotiable note taken from the student, payable in designated installments in accordance with the terms of the note. Under the contract the student agreed to take a designated number of hours of dancing lessons and pay therefor the amount specified as tuition. All types of contracts contained a non-cancellable provision and provided that the student should not be relieved of his obligation to pay the tuition agreed upon. The hours of lessons or instructions contracted for ranged from 5 to 1,000 or 1,200. Some of the contracts were for lifetime courses which meant that, over and above 1,200 specified hours, the student was entitled to 2 hours of lessons per month, plus two parties a year for life. By explicit terms, the studio was required to give the number of hours of instruction agreed upon. The contracts, however, did not schedule the dates when the studio was required to give and the student was to receive instructions, this detail being arranged and agreed upon from time to time as lessons were given. (R. 249-250) However, every contract specifically provided for an expiration date. (R. 146-149, Exs. 15-O to 20-T, inclusive.) Under many of the contracts, lessons extended beyond the fiscal year in which the contract had its inception. (R. 250)

Notes taken from students were transferred with full recourse to a local bank, which at the time of acquiring a note would deduct therefrom the interest charges and give approximately 50 per cent of the balance of the note to petitioners. Installment payments by students on the remainder of the note were held by the bank in a reserve account, but this reserve was not available to petitioners until the note was paid



in full by the student, after which the reserve was transferred to the partnership's general bank account. (R. 250-251)

A sizeable number of contracts was cancelled annually, the non-cancellable provision to the contrary notwithstanding. In its opinion, the Tax Court found that "cancellations were considerable in amount," noting that records of the partnership disclosed that cancellations for the respective years involved were 17 per cent, 15 per cent, and 19 per cent of sales (contracts signed) for the respective years.<sup>1</sup> (R. 258)

A complete double entry bookkeeping system was installed for the partnership when organized in 1946, and at the same time an accrual system of accounting was adopted with the fiscal year ending March 31. The bookkeeping system was designed and installed by a certified public accounting firm. This accounting system was used continually and consistently from the time the partnership was formed. Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract. (R. 251-252)

When a contract was entered into with a student, the "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and determination was made of the number of hours of lessons

<sup>1</sup> Petitioners contend that the Tax Court's percentages of cancellation are inaccurate; sales in the amount of approximately 28.4 per cent, 19.1 per cent and 25.2 per cent were cancelled in the fiscal years 1952, 1953 and 1954. (R. 191, Pet. Ex. 24)

taught which, multiplied by the rate per hour of each contract, gave the amount of income earned. The deferred income account was then reduced by that amount and an earned income account increased by the same amount. Earned income thus arrived at was reported as income on the partnership's tax return. If there was any gain resulting from the cancellation of a contract, this amount was also considered as taxable income and reported as such. (R. 252-258)<sup>2</sup>

The uncontradicted testimony of the accounting experts was that the system of accounting employed by taxpayers accurately reflected true income. Moreover, this uncontradicted testimony was that the method of accounting used was the only method which would do so. The Tax Court made no finding that taxpayers' system of accounting did not reflect their true income. (R. 248-257, 194-195, 231-233, 241-242)

Under the Commissioner's method of computing income, this successful and growing business would have have had an actual cash deficit of \$15,259.92 at the end of the fiscal year ended March 31, 1954. As of the same date, the partnership was under the contractual obligation to teach 31,677 hours of dancing lessons. (R. 206-209, Pet. Ex. 28; R. 189-191, Pet. Ex. 24.)

The Commissioner determined that the entire amount of the contract price was income in the year in which the contract was entered into. (R. 258) Accordingly, in his notices of deficiency he increased the ordinary net income of the partnership for the fiscal years in-

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<sup>2</sup> Detailed schedules which correctly and precisely reflect the result of the partnership's accrual system of accounting during the years in question appear in the Findings of Fact of the Tax Court. (R. 254-256)

volved by the amounts of the increases in the "deferred income" account in those years. (R. 256) The increases in the deferred income account in the fiscal years ended March 31, 1952, 1953 and 1954 are as follows: \$24,602.22 in 1952, \$104,798.41 in 1953, and \$12,797.97 in 1954. (R. 256) The Tax Court, three Judges dissenting, sustained the Commissioner's determination through application of the "claim of right doctrine." This means that, for income tax purposes, the full amount of the contract price had to be returned as income in the year in which the contract was entered into, irrespective of the amount of money collected and irrespective of the actual rendering of service or of any obligation on the part of the partnership to render services under the contract in years subsequent to the year in which the agreement was made. (R. 246-264) The Court of Appeals, one Judge dissenting, on October 19, 1960, reversed the Tax Court. (R. 278-291) The Court in part stated: (R. 288)

"Even assuming arguendo that petitioners received cash payment in full at the time of contracting, the receipt of the funds could not be considered to be earned until petitioners had discharged their liabilities under the contract. Under their method of accounting, established when the partnership was formed and continually employed thereafter, petitioners reported as income in their tax returns such portion of the total amount received, as under their system of accounting had

"This is not a situation where taxpayers are attempting to change their method of accounting. See *Brann v. Helvering*, 291 U.S. 193; *United States v. Anderson*, 269 U.S. 422; *Bureau Publishing Co. v. Commissioner of Internal Rev.*, supra, at pp. 701-702. Three qualified experts testified that the system here employed *did* reflect true income and in fact was the only method which would do so.

been earned, deferring the remainder of the amount received for inclusion in the year or years in which the remainder of their liability was discharged. Such system seems eminently designed to reflect true income."

After this Court granted the respondent's petition for certiorari, it vacated the judgment and remanded the case. Subsequently, after petition for rehearing, this Court amended its order to remand so as to remand the case "for further consideration in light of *American Automobile Association v. United States*." (Italics supplied) On remand, the Court below held that under the *American Automobile Association* case petitioners' method of accrual accounting "does not, for income tax purposes, clearly reflect income," and vacated its previous judgment and affirmed the decision of the Tax Court.

## SUMMARY OF ARGUMENT

### I

The primary requirement of the taxing statutes is that each taxpayer is required to make a return of his true income. Since the Revenue Act of 1916 the accrual method of accounting has been recognized as an accounting system that "clearly reflected income." In *United States v. Anderson* (1926), 269 U.S. 422, this Court explained the purpose of accrual accounting to be the matching of income with related costs in the same taxable period. Sections 41 and 42 of the Internal Revenue Code of 1939, and sections 446 and 451 of the Internal Revenue Code of 1954 are the statutory basis for using the accrual method of accounting. The statute and regulations require that the Commissioner must follow the method of accounting used by the tax-

payer in keeping his books if that method clearly reflects income. Consequently, since the accrual method of accounting is an approved method that clearly reflects income, the partnership has reported its true income.

## II

The Courts below held that the entire contract price for dancing lessons was income at the time the contract was entered into rather than in the period when earned by the performance of services. This holding is in error as a matter of general law, as well as from an income tax and accounting standpoint. It disregards the basic precept of accrual accounting which holds that a clear reflection of income is obtained only by matching in a given period related revenue and expenses. The result is a complete distortion of the partnership's income because costs incurred to produce income are not properly matched against the income. The holding is wrong as a matter of general law since the partnership had no right to enforce payment of the full contract price under the executory contracts before rendering the service. It would only be entitled to recover damages arising from the breach of contract on the part of the student. This is generally measured by the loss of anticipated profits.

## III

The Court below held that in the light of *American Automobile Association* case, the partnership's method of accounting did not for income tax purposes clearly reflect income. The Court below misinterpreted and misapplied *American Automobile* in view of the factual difference between the cases. In *American Automobile* the Court found it did not accurately reflect in-

come because the system was based on statistical computations and averages reflecting the over-all cost of rendering services to all its members on a group or pool basis. The Association was unable to establish the cost of rendering service to an individual member. The system used by the Association simply prorated the membership dues by the number of months and bore no relationship to the services to be rendered. In the case at bar the method of accounting for advance receipts accurately and precisely matched revenues in each tax year with related costs of rendering the services. This was easily accomplished because of the type of business and the card system employed. Despite the factual differences in the two accounting systems, the Court below rejected the partnership's accrual system on the authority of the *American Automobile* case. The *American Automobile* case only involved the taxation of advance cash receipts. It did not involve unreceived and unearned income. Yet the effect of the holding of the Court below is to tax as income the face amount of the contracts on which payment had not been received nor earned by performance of services. In addition, the decision of the Court below is in error in holding that income had accrued on the contracts on which payment had been received but not earned by performance of service. The decisions of this Court make it clear that in accrual accounting the time cash is actually received is not determinative of the time of its inclusion in gross income for purposes of taxation. *Brown v. Helvering* (1934), 291 U.S. 193, and *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182. The basic precept of accrual accounting is the accurate matching of revenues with related cost. When this has been accomplished and true income determined, this Court's decision in *American Automobile* does not



prevent the deferral of advance receipts until the services have been performed and the income earned.

The legislative history of the enactment and repeal of sections 452 and 462 is not authority for disregarding the partnership's accrual accounting system. The Court in *American Automobile*, in giving consideration to the legislative history of these sections of the Code, specifically limited itself to the particular accrual accounting system employed by the American Automobile Association. The enactment and repeal of sections 452 and 462 is not authority for holding that the partnership's method of accounting, which accurately and precisely matches revenues with related expenses so as to reflect true income, can be disregarded.

## ARGUMENT

### 1. THE ACCRUAL METHOD OF ACCOUNTING USED BY THE PARTNERSHIP CLEARLY REFLECTED ITS TRUE INCOME

The primary requirement of the tax law is that "Each taxpayer is required by law to make a return of his true income."<sup>3</sup> The rule has always been, as stated in *Eisner v. Macomber*, 252 U.S. 189, 206, that the income taxing statutes apply only to actual income computed "according to truth and substance without regard to form." In *Welp v. United States* (C.A. 8, 1953), 201 F. 2d 128, it was stated:

"The objective of the Internal Revenue Code is the ascertainment and reporting of *true* income and the payment of the proper tax thereon. That objective should not be subordinated to formal methods or practices of bookkeeping or accounting \* \* \*." (Italics supplied.)

<sup>3</sup>Treas. Reg. 118, Sec. 39.41-3. (App. pp. 5a-6a)

The method of accounting employed by the partnership in the instant case in keeping its books clearly reflected its true income and fully complied with the applicable statutes and Regulations.

Since the Revenue Act of 1916, the accrual method of accounting has been recognized as an accounting system that "clearly reflected income." The legislative history of the Revenue Acts permitting the accrual system of accounting have been exhaustively set forth in many cases. In *United States v. Anderson* (1926), 269 U.S. 422, this Court first discussed the legislative development as follows:

"A consideration of the difficulties involved in the preparation of an income account on a strict basis of receipts and disbursements for a business of any complexity, which had been experienced in the application of the Acts of 1909 and 1913 and which made it necessary to authorize, by departmental regulation, a method of preparing returns not in terms provided for by those statutes, indicates with no uncertainty the purpose of §§ 12(a) and 13(d) of the Act of 1916. It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis."

See: *Aluminum Castings Co. v. Rautzahn* (1930), 282 U.S. 92; *Niles-Cement-Pond Co. v. United States* (1930), 281 U.S. 357; *Helvering v. Union Pacific Railroad Co.* (1934), 293 U.S. 282. See also opinion of Mr. Justice Stewart in *American Automobile Associa-*

*tion v. United States* (1961), 367 U.S. 687, at pages 711-714.

The present statutory basis authorizing accrual accounting for income tax purposes is sections 41 and 42 of the Internal Revenue Code of 1939, and sections 446 and 451 of the Internal Revenue Code of 1954. (App. pp. 2a-4a). Section 41 of the Internal Revenue Code of 1939 and corresponding sections of prior Revenue Acts require that:

"The net income shall be computed upon the basis of the taxpayer's annual accounting period \* \* \* in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but \* \* \* if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. \* \* \*

Section 42 of the Internal Revenue Code of 1939 states the period in which items of gross income shall be recognized as follows:

"The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. \* \* \*

Section 41 requires that the method of accounting used by the taxpayer in keeping his books shall govern the computation of his net income. It is only when the method of accounting used by the taxpayer in keeping its books does not clearly reflect the income that the Commissioner has a discretion to compute his tax by another method.

Treasury Regulations 118, section 39.41-1 (App. pp. 4a-5a) in part provide:

\*\*\* If the method of accounting regularly employed by him [taxpayer's] in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. \*\*\*

The statute and Regulations require that the Commission must follow the method of accounting used by the taxpayer in keeping his books if that method clearly reflects his true income.<sup>4</sup> Moreover, it is equally clear that the accrual method of accounting meets this requirement of the statute.

**II. THE COURTS BELOW ERRED IN HOLDING THAT THE ENTIRE CONTRACT PRICE FOR DANCING LESSONS WAS INCOME AT THE TIME THE CONTRACT WAS ENTERED INTO RATHER THAN IN THE PERIOD WHEN EARNED BY THE PERFORMANCE OF SERVICES**

The majority opinion of the Tax Court, which was affirmed by the Court of Appeals in its second opinion, held that "income" accrued to the partnership at the time the contracts were entered into, and said: (R. 258)

\*\*\* When the contracts were entered into the amounts due thereunder were fixed and the students were 'liable to pay.' It is true that a payment of a portion of the contract price was deferred, but that does not affect the fixed and unconditional right of the Studio to receive the amount. Nor does the fact that the Studio was required to perform future services under the contract alter the Studio's right to receive since the deferred payments were in many cases due prior

<sup>4</sup> See *Huntington Securities Corporation v. Busch*, (C.A. 6, 1940) 112 F. 2d 368, and *John J. Harden v. Commissioner*, (C.A. 10, 1955) 223 F. 2d 418.

to the rendering of the services. And the record shows that in most instances substantial payments were received prior to the performance of the services for which the payments were made."

This statement of the Tax Court is in error as a matter of general law, as well as from an income tax and accounting standpoint. The statement disregards the basic precept of the accrual system of accounting which holds that a clear reflection of income is obtained only by matching in so far as is reasonably practicable in a given period related revenue and expenses.<sup>5</sup> As noted before, this basic precept of accrual accounting was recognized by this Court in *United States v. Anderson* (1926), 269 U.S. 422, and *Helvering v. Union Pacific Railroad Co.* (1934), 293 U.S. 282, and other cases. The effect of compelling the partnership to include in income the entire contract price in the year the contract is signed is to grossly distort this taxpayer's true income.<sup>6</sup>

<sup>5</sup> Accountants' Handbook; Paton, 4th Ed. Wixon, Sec. 1, pp. 13-14; Finney & Oldberg, *Lawyers' Guide to Accounting*, p. 49 (1955).

<sup>6</sup> The Commissioner's distortion of income is illustrated by the undisputed fact that although under the Commissioner's method gross income (evidenced by contracts signed during the year) increased from \$430,293.65 in fiscal 1953 to \$452,040.70 in fiscal 1954, or a 5% increase in sales (signed contracts), the net profit or taxable income for fiscal 1954 was actually decreased 55% despite a 5% increase in sales. Under the Commissioner's method net profits equalled 33.5% of gross income for fiscal 1953 as compared to only 14.4% for fiscal 1954. On the other hand, on the accrual basis used by the partnership, gross income increased 34.06% for fiscal 1954 over fiscal 1953, and the net profit was increased 32.3%. Under the partnership method, net profit equalled 15% of gross income in fiscal 1953 and 14.7% of gross income in fiscal 1954. (R. 213215, Pet. Ex. 31.) This shows that the Commissioner's method results in a distortion of income because costs incurred to produce income are not properly matched against the income.

Furthermore, as stated above, the statement of the Tax Court that when the contracts were entered into the amounts due thereunder were fixed and the students were liable to pay, is wrong as a matter of general law. When a taxpayer, using the accrual method of accounting, enters into a contract to perform services in the future, and to receive payments in the future, all events which fix the right to receive income have not occurred and will not occur until the services are actually rendered. The question here is whether the taxpayer has a fixed right, upon entering into a contract, to receive as income the contract price. *Spring City Foundry Co. v. Commissioner* (1934), 292 U.S. 182.

As long ago as 1922, the Solicitor of Internal Revenue, in L. O. 1086, I-1 Cum. Bull. 87, 89, stated the rule as follows:

“\* \* \* in order to be accruable in the taxable year for which a return is made, a valid right to income must have arisen or existed in that year, which is enforceable on the date the income is due.” (Emphasis added)

The partnership had no right to enforce payment of the full contract price under the executory contracts before rendering the service. The partnership would only be entitled to recover damages (generally measured by the loss of anticipated profits) arising from the breach of contract on the part of the student. 5 Williston on Contracts, Sec. 1351, (Rev. Ed. 1937). In *United States v. Speed*, 8 Wall (75 U.S. 77), the government contracted with a butcher whereby he was to slaughter and pack hogs for the Army back in the Civil War days. The government cancelled the contract after it



was about one-third fulfilled. This Court held that the contractor was entitled to the agreed price, less the expense of fulfilling the remaining part of the contract.

In the case of *Levin v. Commissioner* (C.A. 3, 1955), 219 F. 2d 588, affirming 24 T.C. 996, a partnership, of which the taxpayers were members, executed a contract in December 1946 for advertising services which required services to be rendered from December 1946 to December 1947. In the taxable year 1946 the full amount of the contract price was accrued and claimed as an expense deduction by the taxpayers. The Court of Appeals, in affirming the Tax Court, held that the liability for payment of services to be rendered in the future did not accrue at the time the contract was executed and said:

"It is well settled and taxpayers seem to agree that a liability does not accrue so long as it remains contingent. *Diric Pine Products Co. v. Commissioner of Internal Revenue*, 1944, 320 U.S. 516, 64 S. Ct. 364, 88 L. Ed. 420; *Brown v. Helvering*, 1934, 291 U.S. 193, 54 S. Ct. 356, 78 L. Ed. 725; *United States v. Anderson*, 1926, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347. They argue, however, that as the contract provided for cancellation only at the end of a year, liability became fixed for a year's services upon its execution. We do not think that provision determinative of the nature of the partnership's liability. The contract called for the display of cards by the transit company in the future. Rendition of the services was a condition precedent to any obligation of the partnership to pay. Where the contract, as here, contains mutually dependent promises, liability under it is contingent upon performance or tendered performance. Restatement, Contracts § 270 (1932) et seq.

Taxpayers also argue that the moment the contract was signed there was a fixed and determined liability for damages if they breached the contract in 1946. True; if they had breached the contract in 1946, some amount (though not necessarily \$8,796) might have become a fixed and determined liability, but the fact remains that there was no breach in 1946."

The law of Nebraska, Iowa and South Dakota follows the general rule that a party seeking to recover on an executory contract before performance is rendered is only entitled to recover damages for the breach which is measured by the loss of profits. *International Text-Book Co. v. Martin*, (1908), 82 Neb. 403, 117 N.W. 994; *King Features Syndicate v. Courier* (1950), 241 Iowa 870, 43 N.W. 2d 718; South Dakota Code, Sec. 37-1801 (1960 Supp.).<sup>7</sup> The foregoing authorities demonstrate that as a matter of general law the Tax Court was in error in holding that when the contracts were entered into the amounts due thereunder were fixed and the students were liable to pay.

### III. THE AMERICAN AUTOMOBILE ASSOCIATION CASE IS NOT DISPOSITIVE OF THE ISSUE IN THE CASE AT BAR

The per curiam opinion of the Court of Appeals on remand (R. 273-274) held that in the light of *American Automobile Association*<sup>8</sup> case, the taxpayer's method of accrual accounting does not for income tax purposes clearly reflect income. The factual differences between the present case and the *American Auto-*

<sup>7</sup> South Dakota Code, Sec. 37-1801 (1960 Supp.):

"No person can recover a greater amount in damages for the breach of an obligation than he could have gained by the full performance thereof on both sides • • •"

<sup>8</sup> 367 U.S. 687 (1961).

*mobile* case makes it clear that the Court below misinterpreted this Court's decision in the *American Automobile* case. In *American Automobile*, this Court approved the exercise by the Commissioner of his discretion in rejecting the accrual accounting system employed by the taxpayer which deferred the reporting of income to subsequent years. The Court found that the accounting system used by the Association did not accurately and factually match revenues with related costs because it was based on statistical predictions and averages reflecting the over-all cost of rendering services to all its members on a group or pool basis. The Association was unable to establish the cost of rendering service to an individual member. There, the accrual accounting system simply prorated the membership dues by the number of months and bore no relationship to the services to be rendered.

In the case at bar, the method of accounting for advance receipts accurately and precisely matched revenues from services performed in each tax year with related costs of rendering the services. The dancing business operated by the partnership was the type of business that easily enabled it to record the revenue from each contract and the cost of performing under each contract. This was accomplished by use of the individual card for each student. On the card there was listed all pertinent information, including type of contract, hours of instruction involved, total contract price, history of lessons taught and payments made under the contract. (R. 252) The gross income from each contract was determined for each year by multiplying the hours taught by the hourly rate applicable to that contract. Costs were incurred in the period

that the partnership rendered services under the contract. (R. 193-195, 252.)<sup>2</sup> The statistical approach employed by the *American Automobile* system cannot be compared with the accurate and precise card system used by the partnership here involved. Yet, the Court below, applying this Court's decision in the *American Automobile* case, rejected the taxpayer's accrual accounting system which accurately and precisely matched revenues derived from the performance of services in the same taxable year with the cost of rendering such service. The Courts below held that the entire contract price of the executory service contracts was income in the year in which the contracts were signed, even though the taxpayer could not receive nor earn the contract price except by performing services in a subsequent tax year. The *American Automobile* case only involved taxation of advance cash receipts. It did not involve unreceived and unearned income.

**A. The Court below erred in holding income had accrued on the contracts on which payment had not been received nor earned by performance of services.**

The Court below held that the entire contract price is income when the contract was signed even though the contracts were executory in that many payments were not due to be made until a subsequent taxable year.<sup>3</sup> No income had been earned under the contracts because the dancing lessons were not scheduled to be given until a subsequent year. This distinguishes the instant case from the *American Automobile* case which was dealing only with advance cash receipts paid to

<sup>2</sup> See dissenting opinion of three Tax Court Judges. (R. 262-264).

the Association for which there may or may not have been future services required.

The taxpayers in the instant case derived income from the teaching of ballroom dancing, not the signing of contracts. The signing of an executory contract, wherein a student promises to pay for lessons to be given in the future, does not meet the definition of when income accrues as stated in *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184, as follows:

"Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues."

\* \* \*

While the contracts were executory, and until the dancing lessons were given, no income was *earned* and consequently, could not accrue. The "event" giving rise to income was the giving of the dancing lessons. Until the lessons were given there was no "right to receive" an amount which had become fixed within the meaning of the accrual accounting concept. Cf. *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182; *Brown v. Helvering* (1934), 291 U.S. 193. The Court below misapplied the *American Automobile* case in failing to distinguish between a taxpayer who had received advance cash receipts for which it might not be called upon to perform services and a taxpayer who had not

<sup>10</sup> Respondent recognized this in its Brief for the Respondent in Opposition, No. 793, Supreme Court, 1961 Term pp. 20-11, where it was stated, "Since the AAA case in fact involved only actual cash receipts, the Court cannot be said to have passed on this precise question in that case."

received advance receipts nor rendered any services. The difference between sales (as evidenced by contracts signed during the year) and cash received during the year equalled \$48,200.43, \$115,609.39 and \$80,791.54 for 1952, 1953 and 1954, respectively.<sup>11</sup> In addition, the record in the instant case shows that there was no assurance whatever that payments would in fact be made on the contracts in future years. The Tax Court's opinion points out that cancellations were considerable in amount. A large number—over 20%—of the service contracts were cancelled during the years here involved. In addition, other contracts were required to be rewritten for a smaller number of lessons than had originally been contracted for in order to retain the student and not have the contract cancelled in its entirety. (R. 192, 239) In view of the foregoing, it is unrealistic to assume that the partnership would receive the unpaid portion of the contract at the time it was signed by the student. Until the services were rendered and the income earned, the partnership did not have a "fixed and unconditional right to receive the amount" due under the contract.

**B. The Court below erred in holding income had accrued on the contracts on which payment had been received but not earned by performance of services.**

The *American Automobile* case is not authority for holding that an accrual accounting system that accurately and precisely matches revenues derived from services performed in a tax year with related items of cost and expense may be rejected by the Commissioner

<sup>11</sup> The above amounts were arrived at by subtracting "Cash receipts" on Pet. Ex. 28, R. 209 from "Additions During Year—Contract Amount of Sales" on Pet. Ex. 24, R. 191.



as not clearly reflecting income. The decisions of this Court are uniform in pointing out that in accrual accounting the time when cash is actually received is not determinative of the time of its inclusion in gross income for purposes of taxation. In *Brown v. Helvering* (1934), 291 U.S. 193, 199, the Court stated:

"If the accounts are kept on the accrual basis the income is to be accounted for in the year in which it is *realized* even if not then actually received; and the deductions are to be taken in the year in which the deductible items are incurred." [Italics supplied]

In *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 185, the Court stated:

"Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive and *not the actual receipt* (italics supplied) that determines the inclusion of the amount in gross income. When the *right* to receive an amount becomes fixed, the right accrues. When a merchandising concern makes sales, its inventory is reduced and a claim for the purchase price arises."

See also *Security Flour Mills Co. v. Commissioner* (1944), 321 U.S. 281, and *Commissioner v. Hansen*, 360 U.S. 446. See Mr. Justice Stewart's dissenting opinion in *American Automobile*, 367 U.S. pp. 711-715. The statement in *Brown v. Helvering*, *supra*, that "Income is to be accounted for in the year in which it is *realized*" (italics supplied) is the equivalent of saying that income is to be accounted for in the year in which it is *earned*.

In the *American Automobile* case the taxpayer failed to prove that the method of deferral used bore any

significant relation to the services to be performed in the future. In the instant case, the deferral bears direct relation to the services to be performed and which are in fact required to be performed under the terms of the contract. The partnership's obligation to provide services subsequent to the tax year was fixed, definite and certain and, furthermore, was identifiable as to untaught hours and unearned contract amount for each student contract outstanding at the end of the year.<sup>12</sup> The important factual distinctions are that in the case at bar (1) there was no pro rata allocation of income to periods on a time elapsed basis; (2) there was no pooling of expenses or a deduction of expenses on a pro rata basis; (3) there was no computation of profits based on average experience in rendering services or performance, and (4) there was no selling of availability of services. In the case at bar, (1) income is returned in the year of actual performance; (2) expenses are deducted when incurred; (3) profit is computed on the basis of actual events or transactions and the exchange of values, and (4) actual services are sold which can be identified for each contract as to the amount of performance rendered and the amount of performance yet to be rendered. Consequently, the case at bar falls within the rules of *Beacon Publishing Company v. Commissioner*, (C.A. 10, 1955) 218 F. 2d 697, and *Schuessler v. Commissioner*, (C.A. 5, 1956) 230 F. 2d 722, because the studio rendered actual dancing instructions to its students on fixed dates as scheduled, in accordance with the terms of the contracts.

<sup>12</sup> The accurate matching of revenue with related cost in the instant case has been referred to by law journal writers as a "sophisticated system" when compared with the "rather crude accounting system" employed by the American Automobile Association, *Journal of Taxation*, August 1962, p. 104.

This is the principle on which this Court distinguished the *Automobile Club of Michigan* case and the *American Automobile Association* case from the *Beacon* and *Schuessler* cases.

In *Automobile Club of Michigan v. Commissioner* (1957), 353 U.S. 180, the *Beacon* and *Schuessler* cases were distinguished factually by pointing out that performance of the subscription in *Beacon* in most cases was in part, necessarily deferred until the publication dates after the tax year. In *Schuessler* it was pointed out that performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year. In the *Automobile Club* cases substantially all the services were performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year. In the case at bar, the dancing students do not buy the availability of services. They buy the actual dancing instruction itself. In the *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, the Court found that (p. 189) "The pro rata allocation of membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member." This is not true in the case at bar. The Court of Appeals in its original opinion in this case pointed this out and said: (R. 289)

"The facts before us are distinguishable. Here, petitioners' obligation to provide services subsequent to the tax year was fixed, definite and certain, thereby effectively rebutting any contention that petitioners' method of deferral was purely artificial. The system and method of accounting on an accrual basis with the deferral of income

so that it could be closely matched to the corresponding expenses, was designed to clearly reflect petitioners' true income within the meaning of the applicable statutes and regulations. As pointed out in the *Beacon* and *Schuessler* cases, any other method would result in a distortion of true income."

It is submitted that this Court's decision in the *American Automobile* case does not prevent the use of an accrual accounting system for tax purposes which accurately and precisely matches revenues derived from services performed in a tax year with the cost of performing such services.

**C. The legislative history of the enactment and repeal of sections 452 and 462 of the Internal Revenue Code of 1954 is not authority to support the Commissioner's action in disregarding the taxpayer's accrual accounting system which accurately and precisely matches revenues and related cost.**

The majority opinion in the *American Automobile* case gave consideration to the legislative history surrounding the enactment and repeal of sections 452 and 462 of the Internal Revenue Code of 1954 in finding that the Commissioner had properly exercised his discretion in disregarding the Association's accounting system. The Court held:

"Finding only that, in light of existing provisions not specifically authorizing it, the exercise of the Commissioner's discretion in rejecting the Association's accounting system was not unsound,  
\* \* \*

Here the majority opinion specifically limited itself to the American Automobile Association's particular

accrual accounting system. The opinion of the Court had previously pointed out a number of reasons why the Association's accounting system did not reflect its true income. The enactment of sections 452 and 462 would clearly have justified the accrual accounting system used by the American Automobile Association. However, since those provisions were repealed, there was no specific provisions authorizing the system used by the American Automobile Association. The enactment and repeal of sections 452 and 462 is certainly no authority for holding that a taxpayer's method of accounting, which accurately and precisely matches revenues with related expenses so as to reflect its true income, can be disregarded. The issue here is whether the accrual method of accounting used by the taxpayer clearly reflected its true income. This issue must be decided by interpreting sections 41 and 42 of the Internal Revenue Code of 1939 and sections 446 and 451 of the Internal Revenue Code of 1954.

The enactment and repeal of sections 452 and 462 did not alter or affect the basic requirement of the law that each taxpayer is required to report his true income. Nor do they change the necessary and inevitable conclusion that when a taxpayer has reported his true income he has complied with the law. Matters of form in the dress of bookkeeping or accounting practices should not be extolled over truth and substance.

### CONCLUSION

The accrual method of accounting used by the partnership clearly reflected its true income. The hybrid system of accounting imposed by the Commissioner results in a complete distortion of income because of a failure to match revenues with related expenses.

Petitioners, therefore, pray that the judgment entered by the Court below should be reversed.

Respectfully submitted,

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September 14, 1962.



## APPENDIX

## Internal Revenue Code of 1939:

## SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service \* \* \*, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. \* \* \*

(26 U.S.C. 1952 ed., Sec. 22.).

## SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; \* \* \* and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(26 U.S.C. 1952 ed., Sec. 23.)

# SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. \* \* \*

(26 U.S.C. 1952 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or

incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions, or credits should be taken as of a different period. • • •

(26 U.S.C. 1952 ed., Sec. 43.)

#### **Internal Revenue Code of 1954:**

##### **SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.**

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) *Permissible Methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

- (1) the cash receipts and disbursements method;
  - (2) an accrual method;
  - (3) any other method permitted by this chapter;
- or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(26 U.S.C. 1958 ed., Sec. 446)

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) *General Rule.*—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income such amount is to be properly accounted for as of a different period.

(26 U.S.C. 1958 ed., Sec. 451).

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) *General Rule.*—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

(26 U.S.C. 1958 ed., Sec. 461.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39. 41-1 *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him

in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

SEC. 39.41-2. *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. (See section 48 for definitions of "paid or accrued" and "paid or incurred.") All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 39.42-2 and 39.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 39.22(c)-5.)

SEC. 39.41-3. *Methods of Accounting.* It is recognized that no uniform method of accounting can be

prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. \* \* \*

SEC. 39.42-1. *When included in gross income.*—(a) *In general.*—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. See §§ 39.41-1 to 39.41-3, inclusive. \* \* \*

SEC. 39.43-1. *"Paid or incurred" and "paid or accrued."* (a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner, together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal



Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

SEC. 39.43-2. *When charges deductible.* Each year's return, so far as practicable, both as to gross income and deductions therefrom should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a growing business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. \* \* \*

#### Treasury Regulations on Income Taxes (1954 Code).

SEC. 1.446-1. GENERAL RULE FOR METHODS OF ACCOUNTING. (a) *General Rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combina-

tions of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) *Permissible methods.*—(1) *In General.* Subject to the provisions of paragraphs (a) and (b) of this

section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.*—Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451-2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and paragraph (a)(1) of § 1.461-1.

(ii) *Accrual method.*—Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise, the extent to which indirect costs shall be included in computing cost of goods sold depends upon

the method used by the taxpayer in treating such items in keeping his books.

SEC. 1451-1. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.—(a) *General Rule*.—Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations

thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and § 1.706-1(a). If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

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IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1962

MARK E. SCHLUDE and MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

ON ~~WRIT OF HABEAS CORPUS~~ WRIT OF CERTIORARI TO THE UNITED STATES  
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF AMICUS CURIAE OF AMERICAN INSTITUTE OF  
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IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1962

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No. 80

MARK E. SCHLUDE and MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

---

ON  WRIT OF CERTIORARI TO THE UNITED STATES  
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

---

**BRIEF AMICUS CURIAE OF AMERICAN INSTITUTE OF  
CERTIFIED PUBLIC ACCOUNTANTS**

---

**STATEMENT OF INTEREST OF THE INSTITUTE**

The American Institute of Certified Public Accountants is a nation-wide professional organization of more than 42,500 certified public accountants out of a total of approximately 70,000 in the United States. It is a non-profit organization chartered under the laws of the District of Columbia, and is the only national professional organization of certified public accountants. Its membership embraces certified public accountants from every state and territory, and from the District of Columbia and Puerto Rico.

The Institute and its members have a profound interest in maintaining a proper relationship between accepted accounting principles and accounting for tax purposes. They believe the decision of the Court of Appeals for the Eighth Circuit in *Schlude v. Commissioner* has erroneously construed and applied this Court's decision in *American Automobile Association v. United States*, 367 U.S. 687, in a manner that will have a far-reaching and adverse impact upon many taxpayers who report income on the accrual basis. Reversal of the decision below, the Institute believes, is required to assure the proper administration of the federal income tax laws and to avoid unnecessary confusion, uncertainty and litigation that may otherwise develop in the field of tax accounting by accrual basis taxpayers. The Institute, accordingly, submits this brief *amicus curiae* in support of the position of the taxpayers in the *Schlude* case and urges that the decision of the Court of Appeals be reversed for the reasons set forth below.

The consent of the parties to the filing of this brief *amicus curiae* has been filed with the Clerk of the Court.

#### **OPINIONS BELOW, JURISDICTION AND STATUTES INVOLVED**

The Institute respectfully refers the Court to the brief of the taxpayers for the statement of the Opinions Below, Jurisdiction and Statutes Involved.

#### **QUESTION PRESENTED**

The question presented is: When an accrual basis taxpayer's method of accounting accurately matches revenues derived from services performed in the tax year with related costs, does the decision in *American Automobile Association v. United States*, 367 U.S.



687, authorize the Commissioner to tax as income the entire face amount of long-term executory service contracts in the year such contracts are signed even though a large portion of amounts received under the contracts in that year has not yet been earned and another large portion of the face amount of the contracts has been neither received nor earned?

#### STATEMENT

Petitioners operated a partnership that provided dance instruction services. The students taking instruction paid a portion of the face amount of contracts entered into with the partnership when the contracts were signed and promised to pay the remainder thereafter in installments (R. 146-149, 160, 249-250). The contracts giving rise to the income here in question ordinarily ran for a period greater than a single tax year (R. 184, 250). Although the contracts bound the partnership to perform the required services, the dates for each hour of instruction were not scheduled in the contracts but were agreed to from time to time with the student as individual lessons were given (R. 227, 249-250). Each contract, however, provided a period certain before the expiration of which all the hours of instruction contracted for were required to be taken.

Under some contracts a student made all subsequent payments directly to the partnership. Under another type of contract the student made a part of the subsequent payments to the partnership and another part, evidenced by the student's negotiable note, to a bank to which the partnership had transferred the note. Upon such transfer, the bank deducted interest charges, paid approximately 50 percent of the balance of the note to the partnership and retained the remainder in a reserve account which the partnership could not draw upon until the student had paid the note in full (R. 146-149, 160-161, 250-251). ("R." references are to the printed record in this Court.)

and was reported as income on the accrual basis in the partnership's tax return for that year (R. 185-188, 251-256).

Contending that the entire face amount of each contract constituted income to the partnership in the year in which the contract was signed, the Commissioner rejected the partnership's accounting system for tax purposes and instead increased the net income of the partnership for each of the tax years 1952, 1953, and 1954 by some \$24,000, \$105,000 and \$13,000—the total increase in the "deferred income" account for each such year (R. 256-258). On this basis, he determined deficiencies against the taxpayers for those years of some \$18,000, \$83,000 and \$11,500, respectively (R. 247). The Tax Court, three judges dissenting, sustained the Commissioner's ruling. It held that the entire face amount of each contract was income in the year in which it was signed, although in that year a large portion of amounts collected from the student was as yet unearned by performance and another large portion of the face amount of the contract remained both uncollected and unearned (R. 246, 258).

The Court of Appeals for the Eighth Circuit reversed and held that the accrual accounting system used by the partnership was "eminently designed to reflect true income" (R. 288). This Court thereafter granted a Writ of Certiorari on the Petition of the Commissioner, vacated the judgment of the Court of Appeals and remanded the case to that court "for further consideration in light of *American Automobile Association v. United States*, [367 U.S. 687]. See 367

Any gain arising from the cancellation of a contract by a student or by the partnership where no instruction had been given for a year was also reported as income on the tax return (R. 192, 253).

U.S. 911 and 368 U.S. 873. On remand the Court of Appeals rendered a *per curiam* opinion in which it affirmed the decision of the Tax Court (R. 273). Citing nothing more than the *American Automobile* decision, the court stated: "In light of that case we have carefully examined and considered petitioners' method of accrual accounting and are convinced that such method does not, for income tax purposes, clearly reflect income" (R. 274). On May 28, 1961, this Court issued a Writ of Certiorari on the Petition of the taxpayers (R. 276).

#### SUMMARY OF POSITION OF THE INSTITUTE

##### I

*American Automobile Association v. United States*, 367 U.S. 687, does not bar taxpayers from using the accrual method of accounting for advance receipts whereby the reporting of such amounts as income may be postponed to a later tax year if, by such postponement, such method accurately and precisely matches revenues from services performed in each tax year with related costs of performance. That decision held only that the Commissioner of Internal Revenue is empowered to disregard such method if it does not precisely and accurately match the taxpayer's cost of performing services for individual customers with revenues derived from each such customer.

The discussion by the majority of the Court in *American Automobile* of the enactment and repeal of Sections 452 and 462 of the Internal Revenue Code of 1954 does not support any broader reading of that decision to bar the use for tax purposes of any method

of accrual accounting for advance receipts, no matter how accurate and precise, because it may involve reporting such receipts as income in a subsequent tax year. The Court's consideration of these Code sections had application only to the particular accrual accounting method presented in *American Automobile*, in which the taxpayer used over-all estimates and averages of costs to determine when the advance receipts there involved were reportable as income. Moreover, to read into this portion of *American Automobile* any broad rejection of accrual accounting for advance receipts would disregard legislative and administrative developments that have occurred subsequent to the decision in that case.

Any such broad interpretation would, in addition, conflict with fundamental principles governing accrual accounting for tax purposes that the Court has developed over the years commencing with *United States v. Anderson*, 269 U.S. 422. That case and the subsequent consistent precedents of the Court in this field establish that: 1) as to the reporting of receipts as income, "all events" must have occurred that fix an accrual basis taxpayer's right to funds that may previously have been paid to him—or that may still be due; and 2) as to taking deductions, "all events" must have occurred that fix such a taxpayer's obligation with regard to an expense that may previously have been paid by him—or that he may be required to pay. *Continental Tlx & Lumber Co. v. United States*, 286 U.S. 290; *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182; *Security Flour Mills v. Commissioner*, 321 U.S. 281; *Levy Corp. v. Commissioner*, 349 U.S. 237; *Consolidated Edison Co. v. United States*, 366 U.S. 380.

These decisions supply no warrant for selecting any year in which to tax receipts of an accrual basis taxpayer other than the year in which the receipts—whether received or to be received—are earned by the taxpayer's performance. This rule is in full accord with the relevant provisions of the Internal Revenue Code and the Treasury Regulations that govern accounting for income tax purposes. It is further supported by the adverse practical consequences that would result from requiring accrual basis taxpayers to report receipts as income no later than the year of receipt.

## II

The accrual accounting method for advance receipts used by the taxpayers in *Schlude* fully satisfied the standards set forth in *American Automobile* with regard to matching receipts with the costs of performance. Income was reported in each tax year precisely to the extent it was earned by the taxpayers in fulfilling contracts with students that year. It is not significant in appraising the taxpayers' method of accrual accounting for tax purposes that the contracts did not definitely schedule the performance of services by the taxpayers in years subsequent to the year in which a contract was entered into. This uncertainty as to the taxpayers' performance could not affect their reporting of all receipts as income. Under the taxpayers' accounting practice, all income from each contract was reported not later than the year in which the contract expired, which was fixed in every case, or earlier if the student cancelled the contract or took no instruction for one year.

### III

The error below is highlighted by the ruling that the *Schlude* taxpayers must report as income in the year of execution portions of the face amount of the service contracts that were neither received nor earned by the taxpayers. Nothing in *American Automobile* supports such a result. Nor does *Commissioner v. Hansen*, 360 U.S. 446, where the accrual basis taxpayers—unlike the taxpayers in *Schlude*—had fully performed their obligations under contracts with customers and had accordingly earned all of the contract price.

The method of accrual accounting as used in *Schlude* was as accurate in fixing the year for taxing uncollected portions of the service contracts as it was in fixing the year for taxing advance receipts. For this reason the improper extension of *American Automobile* to amounts not yet collected would be remedied if the Court held the *Schlude* taxpayers' accounting method proper for tax purposes.

#### POSITION OF THE INSTITUTE

The *Schlude* case presents the Court with a needed opportunity to clarify the principles that govern accrual accounting for advance receipts in federal income tax law. This opportunity, the Institute respectfully submits, is most timely. The Court's decision in *American Automobile Association v. United States*, 367 U.S. 687, although reviewing and restating the applicable law, left unanswered substantial questions that *Schlude* squarely presents. Without resolution of these questions by the Court, it appears likely that controversy in this area between the Commissioner of Internal Revenue and accrual basis taxpayers will persist. Cf. *Automobile Club of New York v. Commis-*



sioner, 394 F.2d 781 (2d Cir. 1962), *aff'g*, 32 T.C. 906 (1959);<sup>3</sup> *Beverley J. Sandegren*, 21 T.C.M. No. 16, Dkt. No. 76622 (1962) (on appeal to the Court of Appeals for the Ninth Circuit); *Smith Motors, Inc. v. United States*, 61-2 U.S.T.C. ¶ 9627 (D. Va. 1961).<sup>4</sup>

From the viewpoint of this *amicus*, the key issue is whether *American Automobile* may properly be construed, as the court below apparently did, to foreclose the use for income tax purposes of accrual accounting for advance receipts because it may postpone reporting of income to a subsequent tax year, notwithstanding that, by such postponement, there is an accurate and precise matching of revenues from services performed in each tax year with related costs of performance. If, as we urge, the Court cannot have intended such a sweeping rule, *Schlude*,<sup>5</sup> of course, presents for decision the question of the validity for tax accounting purposes of the accrual accounting method used by the taxpayers there. Finally, the case requires resolution of a narrower issue which, the Institute considers, is encompassed by the preceding questions. It is whether the face amount of an execu-

<sup>3</sup> In *Automobile Club of New York*, *supra*, two judges of the Court of Appeals for the Second Circuit indicated their view that this Court's decision in *American Automobile* had not shaken the authority of *Bressner Radio, Inc. v. Commissioner* 267 F. 2d 520 (2d Cir. 1959), which permitted advance receipts on television repair contracts to be reported as income in the year repair services were rendered. However, the third member of the panel in *Automobile Club of New York*, although concurring, expressed the view that *Bressner* had been rejected by the *American Automobile* decision.

<sup>4</sup> See Krahmer, J.R., *Taxation of Prepaid Receipts*, 47 A.B.A.J. 1218, 1220 (1961); Note, *Accrual Method of Accounting for Federal Tax Purposes: A Need for Stability in an Area of Confusion*, 48 Va. L. Rev. 731, 742-743 (1962).

tory contract—in *Schlude*, for the performance of services—may be taxed as income to an accrual basis taxpayer in the year in which the contract is signed although a large part of the contract price will be neither received nor earned by the taxpayer until a subsequent tax year.

I. ACCRUAL BASIS TAXPAYERS MAY REPORT INCOME FOR TAX PURPOSES BY USE OF ACCRUAL ACCOUNTING PROCEDURES FOR ADVANCE RECEIPTS THAT ACCURATELY AND PRECISELY MATCH REVENUES FROM SERVICES PERFORMED IN EACH TAXABLE YEAR WITH RELATED COSTS OF PERFORMANCE.

From a commercial and accounting point of view a business man using the accrual method of accounting is not regarded as having income upon merely entering into a contract to perform services or to deliver goods in subsequent years or upon the mere receipt of funds under such a contract. He is regarded as having income only when he has earned it by having performed the services or delivered the goods.<sup>5</sup> On the same basis, it has long been recognized in the income tax laws that receipts should be taxed as income in the tax year in which they are earned, since in this way there is offset against the amount earned the cost of earning it. On the many occasions on which this Court has examined this business and accounting principle it has never rejected its validity, though it has, on occasion, held that particular methods of applying it did not achieve its basic purpose—to bring into the same

<sup>5</sup> See Kohler, E., *Auditing*, p. 432 (1954); Mason, Davidson and Schindler, *Fundamentals of Accounting*, p. 271 (3d ed. 1959); Moonitz and Stachling, *Accounting: An Analysis of Its Problems*, vol. I, p. 309 (1952); Paton and Paton, *Corporate Accounts and Statements*, p. 282 (1955); see also authorities cited at p. 33 below.

tax year the amounts actually earned and the actual costs of earning them.

The *American Automobile Association* case was such a decision. That decision did not reject the use of the accrual principle, as such, for the reporting of advance receipts as income in the year in which they were earned. It did reject the application of the principle by the taxpayer in that case because of defects in bringing together specific receipts and the costs of earning them, which defects are not in any way present in the case now before the Court. Those who argue for a more sweeping interpretation of the *American Automobile Association* case would put it in direct conflict with decisions of the Court that recognize as proper for tax purposes the reporting of income as it is "earned" by an accrual basis taxpayer and with relevant sections of the Internal Revenue Code and regulations thereunder governing tax accounting. And such an interpretation would perpetuate an unwarranted distinction between established principles of commercial accounting and accounting for tax purposes, and seriously distort the reporting of income by many accrual basis taxpayers whose accounting procedures for advance receipts are accurate and precise.

**A. AMERICAN AUTOMOBILE DOES NOT BAR PRECISE AND ACCURATE ACCRUAL ACCOUNTING OF ADVANCE RECEIPTS FOR TAX PURPOSES**

1. *American Automobile* required the Court to rule only whether the Commissioner of Internal Revenue was empowered to disregard the method of accrual accounting for advance receipts used by a taxpayer, a national membership automobile club, which method did not precisely match the portion of the cost of performing services for its individual members in the tax

year with the proper portion of dues revenues prepaid by each member for a twelve-month membership period. Because the number of individual members was large, the taxpayer sought to rely upon its over-all experience in performing services for all of its members in order to determine the cost of service performed for any one member. Its accrual accounting procedures required only that dues be reported as income for tax purposes on a month-by-month basis ratably over the membership period, without regard to the actual cost of services rendered to each member but keyed at best to a statistically calculated cost deemed sufficiently representative of actual cost. 337 U.S. at pp. 688, 690. For this reason the Court considered the *American Automobile* case controlled in essential respects by *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 189, which upheld the Commissioner's rejection for income tax purposes of substantially the same accrual accounting system because recording the accrual of the membership dues paid to the taxpayer "in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the members."

From a tax accounting point of view, therefore, both the *Michigan* and *American Automobile* cases turn on the fact that in recording the accrual of income for tax purposes in any year neither taxpayer could validly demonstrate that there had been precise matching of the portions of the membership dues with the related expenses of rendering services to individual members. This was deemed crucial by the Court in *American Automobile*. Thus, the Court characterized the accrual accounting system there used as one which caused earned income to be reported over the membership

period "without regard to correspondingly fixed individual expense or performance justification" and which was not related to "the actual incidence of cost in serving an individual member" (but was rather on a "group or pool basis") or "in fact related to the expenses incurred." 367 U.S. at pp. 692-693.<sup>6</sup>

The extensive consideration of the adequacy of the taxpayer's accounting practices strongly indicates that the Court's holding in *American Automobile* was only that it was not unsound for the Commissioner to reject that particular method of accrual accounting for advance receipts. From an accounting point of view the Institute earnestly urges that in the present case the Court make clear that its decision in *American Automobile* was confined solely to that issue.

2. The actual holding of the majority of the Court was stated clearly and succinctly by Mr. Justice Clark (367 U.S. at p. 693):

"... [T]he federal revenue cannot, without legislative consent and over objection of the Commissioner, be made to depend upon average experience in rendering performance and turning a profit."

Respondent, however, seeks to support a far broader reading of *American Automobile* and points to the discussion that appears in the opinion of the action of

<sup>6</sup> In *Milwaukee & Suburban Transport Co. v. Commissioner*, 292 U.S. 629 (7-11 Cir. 1964), *cert. denied*, 368 U.S. 976, there was a comparable reliance by the taxpayer upon over-all averages in recording the accrual of deductions for future expenses representing claims lodged against it. This was one basis upon which the Commissioner contended that the *American Automobile* decision sustained his rejection of the taxpayer's method of accrual accounting. See pp. 4-5 of the Memorandum for the Respondent in Opposition to the Petition for Certiorari of the taxpayer in the Milwaukee case, No. 603, October Term, 1961.

Congress in enacting in 1954, and repealing a year later, Sections 452 and 462 of the Internal Revenue Code of 1954. This portion of the Court's opinion, respondent has asserted, recognizes in the Commissioner the discretionary power to bar the use for tax purposes of any method of accrual accounting for advance receipts no matter how accurate and precise, if it may involve reporting such receipts as income in a subsequent tax year.<sup>7</sup>

But Justice Clark made explicit, as we have noted above, that the majority's concern was with a method of accrual accounting that is dependent, in relating costs and revenues, upon "average experience" with expenses incurred by the taxpayer in rendering performance. Accordingly, the consideration in *American Automobile* of the legislative history of the two 1954 Code provisions, which dealt specifically with advance receipts and reserves for future expenses, had relevance only to the particular type of accrual accounting method that was there at issue, in which over-all estimates and averages of expenses were relied upon in determining reportable income.

This is evident from the *American Automobile* opinion itself. It referred to the effect of the legislative history of Sections 452 and 462 upon "the [accounting] practice as was used by the [Automobile] Association here" and upon "the method used by the Association." 367 U.S. at pp. 694-95. Elsewhere it discussed the action of Congress in enacting these sections as "specifically permit[ting] essentially the same prac-

<sup>7</sup> See Brief for the Respondent in Opposition to Petition for Certiorari, pp. 9-10, *Schlud v. Commissioner*, No. 793, Supreme Court, October Term, 1961. See also Memorandum for the Respondent in Opposition to Petition for Certiorari, p. 5, *Milwaukee & Suburban Transport Corp. v. Commissioner*, No. 603, Supreme Court, October Term, 1961.



tice as was employed by the Association here"; the sections were described as the only ones "incontestably permitting," or that "specifically declared" to be acceptable, the method of accrual accounting used by the Association. *Ibid.* Finally, the opinion pointed to repeated unsuccessful attempts by the taxpayer in *American Automobile* to convince Congress to pass legislation which, in terms, would have authorized such membership clubs to use the very same type of accrual accounting system that was under review by the Court. *Id.* at p. 696.

Moreover, to read into this portion of the *American Automobile* opinion any broad rejection of accrual accounting for advance receipts, as respondent appears to urge, would disregard legislative and administrative developments that have occurred subsequent to the decision in that case:

a. On July 26, 1961, shortly after the *American Automobile* decision was handed down, there was enacted a new Section 456 in the 1954 Code (P.L. 87-109, 87th Cong., 1st Sess.) that allowed membership organizations such as the taxpayer in that case to report income as it is earned in performing the service for which their members pay dues. The congressional reports accompanying the enactment of this new section strongly suggest that in repealing Sections 452 and 462 in 1955, Congress did not intend to prohibit the use for tax purposes of all methods of accrual accounting for advance receipts or for reserves for future expenses without regard to how accurately and precisely any such method actually reflected income.

These congressional reports disclose that in taking the action it did in 1955, Congress was not concerned that the use of accrual accounting principles for tax


purposes would permit the reporting of advance receipts as income in tax years subsequent to the year of receipt. Rather, the reports state that in repealing Sections 452 and 462 Congress recognized "the desirability of following generally accepted accounting principles for reporting income for tax purposes," and that the two sections were being repealed only because "Congress became aware of the fact that a large revenue loss was involved" in the "first years of [their] application." H.R. Rep. No. 381, 87th Cong., 1st Sess., p. 2 (1961); S. Rep. No. 543, 87th Cong., 1st Sess., p. 2 (1961). Congress thus appears to have recently acknowledged that the use of proper accrual accounting methods for advance receipts and for reserves for future expenses was permissible for tax purposes before the enactment of Sections 452 and 462 and was not affected by their repeal in 1955.

b. The same conclusion is indicated by the recent issuance by the Commissioner of Internal Revenue of regulations under Section 455, enacted in 1958 to govern taxation of advance receipts for newspaper and periodical subscriptions. These regulations explicitly state that taxpayers who had previously been deferring to a subsequent tax year the recognition of such receipts as income "under an established accounting method" may continue to do so without regard to the specific provisions of Section 455 itself or of the new regulations thereunder.<sup>9</sup>

<sup>9</sup> Regulations § 1.455-5(d) reads:

"Treatment of prepaid subscriptions income under an established accounting method." Notwithstanding the provisions of section 455 and § 1.455-1, any taxpayer who, for taxable years beginning before January 1, 1958, has reported prepaid subscription income for income tax purposes under an established

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**B. BOTH TAX ACCOUNTING LAW AND THE PRACTICAL CONSEQUENCES CALL FOR REJECTION OF ANY BROAD RULE PROHIBITING EVERY APPLICATION OF THE ACCRUAL ACCOUNTING METHOD THAT DEFERS REPORTING OF ADVANCE RECEIPTS AS INCOME TO A SUBSEQUENT TAX YEAR.**

The foregoing analysis of the *American Automobile* decision makes clear that the case constitutes only a determination that rejection of the accrual accounting practices there involved was not an arbitrary decision by the Commissioner. It is also evident from this same analysis that there can be no warrant for joining the two portions of the majority opinion in *American Automobile*, as respondent would urge, to create a rule that prohibits every method of accrual accounting of advance receipts for tax purposes simply because it involves reporting such receipts as income in a subsequent tax year. Not only is any such rule unsupported by *American Automobile* but it is in direct conflict with fundamental principles governing accrual accounting for tax purposes that this Court has developed in an unbroken line of precedent since it decided the landmark case of *United States v. Anderson*, 269 U.S. 422.

1. *The Decisions of this Court.* The *Anderson* case interpreted the tax accounting provisions of the Revenue Act of 1916 (39 Stat. 771), the first tax statute to permit accrual accounting. The Court there required the taxpayer to accrue munitions taxes as a deduction in determining taxable income for a tax year prior to

and consistent method or practice of deferring such income may continue to report such income in accordance with such method or practice for all subsequent taxable years to which section 455 applies without making an election under section 455." T.D. 6591, February 23, 1962 (1962 Int. Rev. Bull. No. 12, at p. 17).

the year in which the taxpayer actually paid such munitions taxes. In ruling that the taxes had accrued in the year that the munitions to which the taxes related were sold (*id.* at p. 436), the Court declared that the purpose of Congress in authorizing the use of accrual accounting methods was (*id.* at p. 440)

" . . . to enable taxpayers to keep their books and make their returns according to scientific accounting principles, *by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period*; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis." (Emphasis added.)

Then, with specific reference to the accrual of the taxes involved in *Anderson*, the Court formulated the "all events" test that since then has served as the over-all standard for determining when an expense is incurred or income is to be reported by an accrual basis taxpayer (*id.* at p. 441):

" . . . In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the [1916]

statute . . . [was] concerned, the taxes had accrued . . . <sup>10</sup>

The Court several years later applied the principles it had formulated in *Anderson* to other cases involving the time for accrual of the same munitions taxes and similar items of expense. *American National Co. v. United States*, 274 U.S. 99; *Nile's Cement Pond Co. v. United States*, 261 U.S. 351; *Aluminum Castings Co. v. Rontzahn*, 282 U.S. 92.

<sup>10</sup> Significantly, the ruling and the language of the Court in *Anderson* echoed the position of the United States in that case. The Government's argument, which is quoted below, might well be included here without any change as the position of the Institute (209 U.S. at pp. 424-425):

" . . . Under the accrual system of accounting, income is said to be accrued when it is definitely receivable, although its payment may not be due, and liabilities or expenses are said to be accrued when the events have occurred from which liability is determined and the liability has become fixed, even though payment is not yet due. The basic idea under the accrual system of accounting is that the books shall immediately reflect obligations and expense definitely incurred and *income definitely earned* without regard to whether payment has been made or whether payment is due. Under this system, the use of the word 'accrued' does not signify that the item is due. On the contrary, the accrual system wholly disregards due dates. Neither is it necessary that the amount of an incurred liability be accurately ascertainable in order to 'accrue' it. Montgomery, *Auditing Theory and Practice*, 3rd Ed. Vol. 1, pp. 239, 240; Esq. *et al.*, *Applied Theory of Accounts*, pp. 299-301; Holmes, *Federal Income Tax*, 1917, pp. 299-301." (Emphasis added.) See Brief for the United States in *United States v. Yale & Towne Mfg. Co.*, pp. 31-32, No. 420, Supreme Court, October Term, 1925 (companion case to *Anderson*).

In light of the Government's then position that accrual accounting methods are designed to reflect "income definitely earned," which the Government equated with "income . . . definitely receivable," it is difficult to understand its position now that advance receipts are "income" when they have not been "earned" or indeed—as in the *Schlude* case—neither earned nor received.



Two subsequent decisions, *Continental Tire & Rubber Co. v. United States*, 286 U.S. 290, and *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, treated the applicability of accrual accounting methods in determining when income is to be reported. It was recognized that accrual accounting might require the taxpayer to report income *before* he receives any payments as a result of the transaction that gives rise to the tax. In language that has often been quoted, the *Spring City* opinion (*id.* at pp. 184-185) declared that for the accrual basis taxpayer

“ . . . it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the *right* to receive an amount becomes fixed, the right *accrues*.” (Emphasis in original.)

The Court chose this manner to restate a basic concept of accrual accounting: that income is to be reported as it is earned. Thus the opinion proceeded (*id.* at p. 185): “When a merchandising concern makes sales, its inventory is reduced and a claim [by it] for the purchase price arises.” Such “sales,” however, do not occur merely when a contract of sale is signed, but rather, as the Court made clear, when the taxpayer performs under the contract—or, in the accounting terms used by the Court, when there are “accounts receivable arising from the sales” (*ibid.*). Similarly, the *Continental Tire* case held, in somewhat different language, that the proper time for accruing income is determined when a taxpayer’s “right to payment ripened” and when he had a “vested right” to payment—in that case upon the passage of legislation assuring that right and before the receipt of any payments by the taxpayer, 286 U.S. at pp. 294-295.

The foregoing decisions present no conflict with other cases in which the Court has declared that the tax statutes require all taxpayers—accrual as well as cash basis—to report “income” for an annual accounting period. It is entirely consistent with the reporting of *income* in an annual accounting period for an accrual basis taxpayer to postpone recognizing *advance receipts* as *income* until the tax year in which such receipts become income—as they are earned by the taxpayer’s conduct of its business. This is the teaching of the cases dealing with the annual accounting requirement, such as *Security Flour Mills v. Commissioner*, 321 U.S. 281, *Lewyt Corp. v. Commissioner*, 349 U.S. 237, and *Consolidated Edison Co. v. United States*, 366 U.S. 380. They do not, we submit, support the erroneous proposition, which has been advanced by the Commissioner, that the annual accounting period concept requires an accrual basis taxpayer to report advance receipts as income no later than the year of actual receipt, regardless of whether earned by performance or not (and correlatively, that deductions must be taken no later than the year in which actually paid even though not yet incurred).<sup>11</sup>

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<sup>11</sup> See Brief for the United States, *American Automobile Ass’n v. United States*, pp. 19-20, No. 288, Supreme Court, October Term, 1960.

The Tax Court apparently embraced this position in the *Schlude* case (R. 258):

“Nor does the fact that the Studio was required to perform future services under the contract alter the Studio’s right to receive since the deferred payments were in many cases due [from students] prior to the rendering of the services. And the record shows that in most instances substantial payments were received prior to the performance of the services for which the payments were made.”

In the *Security Mills* case the Court refused to permit a taxpayer to deduct from gross income in a tax year an item of cost (a flour processing tax) the liability for which the taxpayer denied and payment of which he was contesting in that year. The Court concluded that in these circumstances the tax had not yet been "accrued" as an expense. It therefore required the taxpayer to report as income the amount of the processing tax, which the taxpayer had passed on to its customers, in the year in which it sold the flour subject to the tax. With this background the Court's statement of the annual accounting principle as it applies to accrual basis taxpayers may be properly understood as only a restatement of the rule set forth in the *Anderson* and *Spring City* cases. For such taxpayers, the Court declared, the annual accounting principle requires income or expense to be allocated to "the year in which the right to receive, or the obligation to pay, has become final and definite in amount." 321 U.S. at pp. 286-287. The *Security Mills* case, therefore, like *Spring City*, is a recognition that the controlling issue in the reporting of income by accrual basis taxpayers is not the year of receipt but the year in which "the right to receive" becomes fixed. And a necessary corollary of any such rule is that the "right" arises—whatever the tax year—only when the taxpayer earns the income, regardless of whether it has received payments from, or is yet to be paid by, its customers.<sup>12</sup>

<sup>12</sup> *Brown v. Helvering*, 291 U.S. 193, which prohibited an accrual basis taxpayer from deferring the reporting as income commissions received on insurance policies that ran for more than one tax year, is not to the contrary. Although the taxpayer there had contended that the commission was "compensation for services rendered throughout the life of the policy" and that such compensation "cannot be considered as earned until the required services have been performed," the Board of Tax Appeals had found that

See also *Duric Pine Co. v. Commissioner*, 320 U.S. 516, 518-519.

*Lewyt Corp. v. Commissioner*, *supra*, and the more recent *Consolidated Edison* case confirm this analysis. In the former neither the majority nor the dissenting members of the Court, although disagreeing over what tax year another item of expense (again a tax—on excess profits) had “accrued,” questioned that the basic issue was: in what tax year had the obligation to pay the amount deducted “accrued”? The opinions of the Court contain nothing that even remotely supports the Commissioner’s current view that deductions “accrue,” and therefore must be taken, no later than the year of payment.

This issue was finally and squarely presented and resolved against the Commissioner in *Consolidated Edison*. The Court unanimously held that an accrual basis taxpayer’s deduction, again for a contested tax, is properly taken in the tax year in which a final determination of liability for the tax is made even though the tax had been paid in a prior year. In rejecting the artificial qualification the Commissioner sought to impose upon traditional principles of accrual accounting, the Court made the flat statement that “neither the Government nor an accrual-basis taxpayer may cause an item to be deducted in a year other

there was “no proof that the overriding commissions contain any element of compensation for services to be rendered in future years.” *Id.* at pp. 203-204; 22 B.T.A. 678, 684-685 (1931). The taxpayer thus had failed to establish that the full commissions were not in fact “earned” when they were received in the tax year the policy premiums were paid. As *Bressner Radio, Inc. v. Commissioner*, 267 F.2d 520, 526 (2d Cir. 1959), points out, this Court’s decision “was thus not a departure from but rather an insistence upon sound accrual accounting for earned income.”

than the one in which it accrued." 366 U.S. at p. 385.<sup>1</sup> This recent statement, although made in a case involving the timing of deductions by an accrual basis taxpayer, is equally applicable in determining the tax year in which such taxpayers are to report advance receipts as income.

It is thus evident that a single rule only may be distilled from the Court's decisions that have dealt with the persistent question of when accrual basis taxpayers are to recognize receipts as income, and when they are to deduct expenses from income. The Court has repeatedly determined: 1) as to the reporting of income, "all events" must have occurred that fix the taxpayer's right to funds that may previously have been paid to him or may still be due; and 2) as to taking deductions, "all events" must have occurred that fix the taxpayer's obligation with regard to expense that may previously have been paid by him or that he may yet be required to pay. The prior decisions thus supply no justification for selecting any other year for taxing amounts received than the year in which such amounts—whether received or to be received—are earned as income by the accrual basis taxpayer's performance. No other conclusion is warranted. Accordingly, any policy of the Commissioner that rejects a method of accrual accounting solely because it postpones the reporting as income of amounts received to

<sup>1</sup> The Government's attempt to distinguish the *Anderson, Deen Pine* and *Security Mills* cases on the ground that in *Consolidated Edison* the taxes had actually been paid by the taxpayer in prior tax years was rejected. The Court, moreover, specifically disapproved of *Chestnut Securities Co. v. United States*, 104 Ct.Cl. 489 (1945), and *Consolidated Edison Co. v. United States*, 133 Ct.Cl. 376 (1955), in which the fact of payment of the tax in a prior year had been deemed crucial in determining when the deductible expense had accrued.

tax years subsequent to the year of receipt is without foundation.

2. *The Tax Statutes and Treasury Regulations.* The rule that the decisions of this Court stand for is in full accord with the relevant tax statutes and Treasury Regulations governing accounting for income tax purposes. The statutes and regulations supply plentiful authority for the use by accrual basis taxpayers of accrual accounting methods that precisely and accurately match revenues from services performed in the tax year with related costs of performance, notwithstanding that there may have been advance collection of the revenues. Significantly, these provisions explicitly acknowledge that accrual accounting methods may correctly result in postponing the reporting of advance receipts as income to such taxpayers to a tax year subsequent to that in which they receive such amounts for services to be performed or goods to be delivered thereafter.

It is axiomatic that the Commissioner of Internal Revenue is authorized to recompute a taxpayer's taxable income, as he did in *American Automobile* and in *Schlude*, only if the taxpayer has no regular accounting method "or if the method of accounting used does not clearly reflect income" (emphasis added). Otherwise, "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Int. Rev. Code of 1954, §§ 446(a) and (b); Int. Rev. Code of 1939, § 41. Section 451 (a) of the 1954 Code (1939 Code, Section 42(a)), moreover, specifically provides that the taxpayer's accounting method of computing taxable income may be one in which amounts of gross income—or receipts—are accounted for in tax



years other than the year in which such amounts are received:

"The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.*" (Emphasis added.)<sup>11</sup>

The Treasury Regulations interpreting Sections 446, 451 and their predecessor 1939 Code sections reflect the Commissioner's own recognition of the limits the tax laws place upon his power to recompute a taxpayer's taxable income. Treasury Regulation, 1.446-1(a)(2) states that "a method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income." With regard to the accrual method of accounting, the Regulation incorporates the long established "all events" test for determining the tax year in which an accrual basis taxpayer is to report as income payments that have been or are to be received, or to take deductions for expenses paid or to be paid, in any other tax year.<sup>12</sup> (See discussion, pp. 19-25

<sup>11</sup> It should be emphasized that neither the *American Automobile* majority opinion nor the dissent referred to Section 451 and its language which expressly permits items of receipt to be reported as income in a year that is different from the year of receipt.

<sup>12</sup> Treas. Reg. § 1.446-1(c)(1) (ii) reads in part:

"*Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction.

above.) And Treasury Regulation, § 1.454-1(a), specifically acknowledges that Section 451 of the 1954 Code authorizes an accrual-basis taxpayer to report income in a tax year other than the tax year in which the taxpayer receives payment:

“General rule for taxable year of inclusion—

(a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. *Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the serv-*

and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. *For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books.* (Emphasis added.)

The “manufacturing business” cited as an example of an accrual-basis taxpayer might receive advance payments from customers for products that will be delivered, or title to which will pass to the customers, in a subsequent tax year. The regulation authorizes such advance receipts to be reported as income at that later time. See *Woodlawn Park Cemetery Co.*, 16 T.C. 1067 (1951), acq., 1951-2 Cum. Bull. 4 (prepayment for cemetery crypts); *Veenstra & De Haan Coal Co.*, 11 T.C. 964 (1948), acq., 1949-1 Cum. Bull. 4 (prepayment for coal).

ices are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. . . . (Emphasis added.)<sup>16</sup>

The Treasury Regulations under the 1939 Code similarly recognized that amounts received by an accrual basis taxpayer may be properly accounted for and reported as income in a different tax year than the year of receipt (Treas. Reg. 118, § 39.41-2(a)):

*"Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.*

Section 461 and Regulation, § 1.461 are the comparable provisions governing the proper tax year in which deductions are to be taken. Section 461 reads:

*General Rule. The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.*

Regulation, § 1.461-1(a)(2) reads in part:

*Taxpayer using an accrual method. Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. . . . While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.*

A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. . . . All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, *unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period.* . . . (Emphasis added.)

See to the same effect, Treas. Reg. 118, 39.42-1(a).

(Both the statutes and the regulations thus are entirely lacking in any support for the position that an accrual basis taxpayer who receives amounts in advance from customers that obligate him to perform services in subsequent tax years must report all such amounts as income in the year of receipt. Section 451 is explicit to the contrary, and nothing in Section 446 requires such a result. And the Treasury Regulations refer to situations in which the reporting of income may be postponed to a tax year subsequent to that in which the taxpayer receives such advances. Uniformly requiring the reporting of advance receipts as income in the year of receipt would thus disregard the plain import of the applicable statutes and regulations and would effectively deny the use of accrual accounting for such items. The Institute sees no reasons why, in the face of the long history of the recognition of accrual accounting in the federal tax laws,<sup>17</sup> this result should be desired by the Commissioner or accepted by this Court.

3. *The Practical Consequences.* The substantial adverse consequences that would result from requiring

<sup>17</sup> See *American Automobile Association v. United States*, 367 U.S. 687, 711-712 (dissenting opinion).

accrual basis taxpayers to report income no later than the year of its advance collection supply additional reasons for rejecting any such rule.

"a. In the judgment of the Institute unnecessary differences between established principles of commercial accounting and accounting for tax purposes should be eliminated wherever possible. This objective has been frequently voiced by the Institute<sup>27</sup> and has been urged by others, including Government officials having responsibility for tax policy.<sup>28</sup> The area of accounting for advance receipts is one in which the Institute believes there is no persuasive reason for according judicial sanction to the distinctions between commercial accounting principles and tax accounting law that the Commissioner of Internal Revenue has been advocating.

As we have shown above, no considerations that flow from the tax laws and regulations themselves, or from the decisions of this Court, require rejection in this area of the applicability of commercial accounting principles to accrual accounting for tax purposes. To do so, therefore, will produce an unwarranted distinction between commercial accounting and tax accounting. Any such distinction, the Institute respectfully urges, not only lacks a statutory or decisional law basis but does positive harm by requiring accrual taxpayers to account for the same transaction differently for com-

<sup>27</sup> *E.g.*, J. Accountancy, pp. 710 et seq. (Dec. 1952); 20 AFR 291, 295 (Sept. 1953).

<sup>28</sup> *E.g.*, 1954 Budget Message of the President, reprinted in H. Doc. No. 264, 83d Cong., 2d Sess. (1954); S. Rep. No. 475, 83d Cong., 1st Sess., p. 6 (1953); report of Subcommittee 1, at 1-12, H. R. Rep. No. 487, 83d Cong., 1st Sess., p. 2 (1961); report of Subcommittee 4, at 8-10, S. Rep. No. 547, 87th Cong., 1st Sess., p. 2 (1961); same.

mercial purposes than for tax purposes. Surely this result need not be encouraged when it is not required by law and furthers no sought for objective of policy.

b. Acceptance of the rule of accrual accounting for advance receipts advocated by the Commissioner would seriously distort the reporting of "income" by accrual basis taxpayers in the numerous industries in which customers ordinarily make advance payments against the taxpayer's performance of future services.

It is fundamental that an advance payment from a customer is no different from—and is in fact—a financing transaction entered into by the taxpayer; in a practical sense the services that the taxpayer obligates him-

<sup>2</sup> A sampling of businesses on the accrual basis in which this practice is common, of which the Institute is aware, includes the following: Correspondence schools; technical instruction courses such as radio and television repair instruction; investment counseling services; gymnasium facilities; subscriptions to book of car wash certificates; purchase of tax or other legal research services with commitment to keep material therein up-to-date over specified period; purchase of tickets for theatrical, dramatic or musical performances series; purchase involving series of dinners with accompanying entertainment at selected restaurants; bookkeeping work to be performed over 3-year period; service of typewriters and other office equipment; purchase of encyclopedia with commitment to furnish supplementary volumes over next 5 or 10 years; purchase of toll road tickets; purchase of series of beauty treatments; purchase involving TV servicing and repair; purchase of flying lessons or driving lessons; purchase of instruction in foreign languages; contracts for taking of family photographs at half year intervals; contracts to develop film negatives and provide film; premiums paid for health and medical treatment and facilities; contracts to provide telephone answering services; contracts for construction and sale of project homes; contracts to erect prefabricated houses; contracts for building upkeep and maintenance, e.g., window washing services; contracts for exterminators' services and pest control; manufacturers' service contracts, e.g., service contracts on tabulators and computers or on printing equipment.



self to perform constitute repayment of the customer's "loan." At the time such advance payments are made, therefore, and before the taxpayer performs any required services, the payments "are liabilities and should be shown as such." When a taxpayer receives such advances, he has no income. He has at most only an amount that is yet to be offset by his costs of performing services (or producing goods, as the case may be) in part in a subsequent tax year, at which time such part would be included in "gross income." To treat as taxable income funds that the taxpayer has "raised" in advance from his customers will produce a distortion of taxable income. Conversely, taxable

<sup>21</sup> Accountants' Handbook, § 20, p. 8 (4th ed. 1956) states:

"DEFERRED REVENUES. Advances by customers or clients which are to be satisfied by the future delivery of goods or performance of service are liabilities and should be shown as such. These items have often been labeled 'deferred revenues' or 'deferred credits,' and occasionally are classified on the equities side of the balance sheet between liabilities and proprietorship. Such titles are inclined to be misleading, and such classification is unwarranted. The essential peculiarity of such accounts lies in the fact that they are payable in goods or services rather than in cash, and that as a rule a margin of profit will emerge in making such payment. Under no circumstances should these items be offset against outstanding receivables; nor should they be recorded as earned income prior to delivery of goods or rendering the service for which advance payment has been received."

<sup>22</sup> Paton, W. A., "Deferred Income—A Misnomer," J. Accountancy, p. 36 (Sept. 1961).

"If there is a major point upon which there is general agreement in accounting it is that revenue results from the over-all process of production, and not from borrowing or otherwise raising funds. Moreover, for most lines of business, revenue is regarded as recognizable when product is delivered to the customer. It is also axiomatic that net income, if any, is the amount by which total revenue for the period, repre-

income will also be distorted by the improper allocation of costs—that is, by allocation of costs that the taxpayer must necessarily incur in the year of performance to receipts of any tax year other than that year.

sented by the sale value of the delivered product, exceeds all the expenses, losses, and taxes properly applicable to such total revenue. In the face of these basic considerations how can we justify using the word 'income,' even with the qualifying term 'deferred' attached, to describe the amount of a customer advance? Such an advance may be received before the process of production has even been started, before any costs have been incurred, and before anyone knows for certain that any 'income' will ever be realized on the particular operation or contract!"

These distortions of income created by any rule of tax accounting that requires the reporting of receipts as income no later than the year of receipt may be simply illustrated. In the first year that a taxpayer receives advance payments for performance over subsequent tax years, such a rule would show his income to be unrealistically high, since in that year he would not be permitted to deduct costs of performance in subsequent tax years from the advance payments. Of course, new advance payments received in subsequent tax years will be in part offset, and thus not reported as taxable income, by the deduction of performance costs incurred in those years that are attributable to advance payments reported as income in prior tax years. However, the taxpayer's income will continue to be distorted, since performance cost deductions of each year will not be matched with the advance payment items of prior years that necessitated those costs. Thus, in any tax year, if low performance costs that may be all that is required under prior years' contracts are deducted from relatively high advance payments of the current year, reportable income for the current year will be inflated. Admittedly income in any year might be deflated if the converse occurred, i.e., relatively high performance costs attributable to earlier contracts are offset against low advance payments on the current year's contracts. But such inflation or deflation will occur purely by chance and will bear no rational connection to the earning of income by the taxpayer. Finally, if the taxpayer terminates his business, with the result that he receives no new advance payments but is required to incur performance costs under contracts entered into in prior tax years, he will report apparent losses in the amount of such performance costs, even though such contracts may in reality reflect profitable transactions.

See *American Automobile Ass'n v. United States*, 367 U.S. 687, 714 (dissenting opinion); Bierman & Helstein, *Accounting for Prepaid Income and Estimated Expenses Under the Internal Revenue Code of 1954*, 10 Tax L. Rev. 83, 88-89 (1954); Note, *Taxation of Prepaid Income: A Temporary Solution*, 67 Yale L.J. 1425, 1428-1429 (1958).

It is evident that if year-to-year distortion of the taxable income of accrual basis taxpayers having advance receipts is to be avoided, a precise and accurate matching of revenues from services performed in each tax year with related costs of performance should be achieved. Whenever this is possible, any tax accounting rule that requires income to be reported no later than the year of receipt can not be justified.<sup>24</sup>

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<sup>24</sup> The Institute acknowledges that accrual basis taxpayers are required to report advance collections on certain types of commercial transactions as income in the year of receipt. This rule is perhaps most clear in the case of advance collections under a lease. See, e.g., *Hort v. Commissioner*, 313 U.S. 28, 30 (dictum); *Hyde Park Realty Co. v. Commissioner*, 211 F.2d 462 (2d Cir. 1954); *Treas. Reg.* § 1.61-8(a). Although the Institute takes issue with this rule from an accounting standpoint, the taxation of such advance receipts in this manner may be explainable by the fact that the major right which the lessor of premises or other property grants to the lessee at the time he enters into a lease is the right to occupy or use the property, and typically there is little else by way of further performance required of him in subsequent years. In any event, however, that such an established rule exists in this and other areas of tax law does not justify its extension, and thereby the perpetuation of a further unwarranted distinction between commercial accounting principles and tax accounting, to the situation of taxpayers whose advance collections are related to their performance of services that very largely are to be rendered in subsequent tax years.

## II. THE METHOD OF ACCRUAL ACCOUNTING FOR ADVANCE RECEIPTS USED BY THE TAXPAYERS IN *Schlude* ACCURATELY AND PRECISELY MATCHED REVENUES FROM SERVICES PERFORMED IN EACH TAX YEAR WITH RELATED COSTS OF PERFORMANCE.

The question remains whether the accrual accounting method used by the *Schlude* taxpayers precisely and accurately matched revenues derived from services performed in each tax year with the cost of performing such services, and thus reflected "true income." The Institute believes that the accounting method achieved this result and that for this reason the decisions of the Court of Appeals below and of the Tax Court were erroneous.

1. There can be no serious dispute over whether the accrual accounting method used by the *Schlude* taxpayers was such as to satisfy even the stringent standards set forth in *American Automobile* with regard to the matching of receipts with the cost of performance. The *Schlude* taxpayers operated a type of business which—like many others—enabled them to account accurately for receipts from, and costs of, individual business transactions. Under the accounting method used there was recorded on a card for each student who had entered into an instruction contract with the partnership the number of hours of instruction provided to him under his contract in each tax year. The gross income from each contract was determined for each tax year by multiplying the hours of instruction given by the hourly rate applicable to that contract. There were then offset against that year's gross income from all contracts the various costs incurred during the year (R. 185-188).

This accounting method accomplished an appropriate matching of receipts and costs since the partnership's costs were incurred in the period and to the extent that it rendered services under each contract (R. 193-194, 218-219, 252). Typical items of cost incurred by the partnership, such as rent and utilities, were of course readily determinable and, as expense items applicable to all the service contracts, required no allocation among individual contracts. The single major item of cost that varied from contract to contract, depending upon when instruction was given, was the payment of salary to instructors. This cost was precisely allocable to each contract since instructors were paid by the number of lessons taught (R. 194-195). Taxable income of the partnership was thus reported in each tax year precisely to the extent it was earned in fulfilling the partnership's contract with each student that year, as reflected in the partnership's records (R. 185-188, 251-257).

2. The accounting procedures used in *Schlade* leave open only one objection of those that were urged upon the Court to sustain the Commissioner's rejection of the taxpayer's accrual accounting method in *American Automobile*. That relates to the claim that, in *Schlade* as in *American Automobile*, the contracts did not definitely schedule the performance of services by the taxpayers in tax years subsequent to the year a contract was entered into.

Admittedly, *American Automobile* quoted approvingly from the prior *Automobile Club of Michigan* decision in which the Court deemed it to be a factor that

<sup>25</sup> However, while no schedule was set forth in the contract, as each lesson was given the next lesson was scheduled (R. 227).

services in subsequent tax years were performed by the taxpayer "only upon a member's demand" and that "the taxpayer's performance was not related to fixed dates after the tax year." 353 U.S. at p. 489, n. 20; 367 U.S. at p. 691. The substance of the opinion in the more recent decision, however, makes it apparent that the Court's chief concern was not with this aspect of the taxpayer's business dealings with its members. Rather, as we have previously urged (pp. 12-13 above), *American Automobile* emphasized the Association's inability to point precisely to its cost of performing services for individual members in contrast to its over-all costs for all service contracts "on a group or pool basis." *Id.* at p. 693.

Analysis of what is sought to be achieved by a precise and accurate method of accrual accounting for advance receipts reinforces this reading of *American Automobile*. The key aim of accrual accounting for tax purposes, as the Court has often recognized (see cases discussed at pp. 19-25 above), is to determine the proper reporting of taxable income by matching appropriate costs against related revenues of the tax period. If a taxpayer's accounting method is suitable to this task, and if it satisfies the requirement of *American Automobile* for a precise matching of costs and revenues of the tax year that are allocable to individual customers or transactions, there is no reason to attach significance to the fact that the taxpayer will perform in subsequent tax years, and thus incur costs and earn income, only upon the demand of his customers.

This is not to say that a taxpayer who had made advance collections would be authorized to postpone indefinitely the reporting of such amounts as income if it developed that no such customer demand



for performance were made. A common sense application of accrual accounting principles would of course require that after a *period certain* the taxpayer report as income any advance receipts that had not by that time been earned by performance. For this reason, although a taxpayer's ultimate performance under a long-term contract might be uncertain and contingent, its reporting of all advance receipts as income in some year or years would not be.

This was the case in both *American Automobile* and *Schlude*. In the former the taxpayer necessarily reported all advance receipts as income no later than the end of the period for which its service contracts were in force. 367 U.S. at pp. 688, 690. In *Schlude* each service contract required that all the instruction thereunder be taken in a time certain, and accordingly all income would have been reported by the end of that time (R. 146-149).<sup>1</sup> Moreover, all income might have been reported earlier, since the *Schlude* taxpayers' established accounting practice was to report as income the excess of all cash amounts received over income earned by performance on contracts where the contracts were cancelled by students or where no instruction had been given for one year (R. 192-193, 253). There could thus be no avoidance of taxable income by the taxpayers.

The Institute accordingly urges that the factor of uncertainty of performance alone should not be enough to authorize the Commissioner to reject an accrual accounting method—such as that of the *Schlude* taxpayers—that fully satisfies accepted accounting prin-

<sup>1</sup> Each contract included an explicit acknowledgment by the student "that this course of [number of] hours of dancing lessons expires on [specific date]" (e.g., R. 146).

principles in every respect and at the same time gives rise to no loss of revenues to the Government.

II. THE ERROR OF THE COURTS BELOW IS HIGHLIGHTED BY THEIR RULING THAT THE *Schlude* TAXPAYERS MUST REPORT AS INCOME IN THE YEAR OF EXECUTION PORTIONS OF THE FACE AMOUNT OF LONG-TERM CONTRACTS THAT HAVE BEEN NEITHER RECEIVED NOR EARNED.

Because of the manner in which the *Schlude* taxpayers' business was conducted, the decisions of the courts below involved an added element that in no sense could be said to fall within the *American Automobile* case and that, if not reversed by this Court, will have a far more severe impact upon accrual basis taxpayers than any decision affecting tax accounting for advance receipts alone.

The *Schlude* taxpayers carried on their business to a very large extent through executory service contracts under which a student made a down payment and promised to make future payments during the life of the contract, which frequently extended into subsequent tax years (R. 160-161, 184, 250). In addition to ruling that all advance payments actually received under any contract were to be reported as income in the tax year in which that contract was signed, the courts below further held that the taxpayers must report as income at the same time the face amount of the future contract payments to be made by students, even though such payments had been then neither earned nor received by the taxpayers. The decisions below thus required the reporting as income of the entire face amount of each contract in the tax year in which the contract was entered into.

This ruling, the Institute submits, highlights the erroneous understanding by the courts below of fundamental principles governing accrual accounting for tax purposes that should be corrected by this Court.

1. Wholly apart from any question of the adequacy under accounting principles of accounting methods used by accrual taxpayers such as those in *Schlude*, the *American Automobile* decision can not be read to authorize the Commissioner to require that the entire face amount of long-term service contracts be reported as income in the tax year in which the contract is signed. Nothing in *American Automobile* supports such a result. The taxpayer there always received in advance amounts paid by its members as dues and in return for which the taxpayer became obligated to perform services. In requiring the reporting of the advances as income when received, the Court was strongly influenced by the fact that such funds were immediately available to the taxpayer for its use.

In the *Schlude* case, not only were large amounts to be collected under the service contracts in subsequent years, but, the record discloses, there was no assurance whatsoever that such subsequent payments would in fact be made.<sup>27</sup> A great number—almost 20 percent—of the service contracts were cancelled or defaulted by the students; others of the contracts were required to

<sup>27</sup> In the tax years in question—1952, 1953 and 1954—the taxpayers had neither received from students nor earned by performance \$71,570.97, \$124,445.84 and \$119,710.38, respectively, on contracts entered into in each of the above years and in prior years (R. 145, Pet. Ex. 14-N). (The above figures are derived from Exhibit 14-N by subtracting for each year the "Deferred Income Collected-Ending Balance," considering the Reserve Fund held by the bank as not collected (see p. 3, n. 1 above), from "Contract Amount of Deferred Income-Ending Balance."

be rewritten for a smaller number of lessons than had been contracted for initially, in order to persuade students not to cancel or default entirely on the contracts (R. 192, 239). And, the cancellations and defaults took place, and the rewriting of contracts for shorter periods was necessary, even though each contract contained a clause providing that it was noncancellable (R. 146-149, 193). In these circumstances, it is apparent that the taxpayers could by no means expect that they would receive the uncollected portion of a long-term contract signed by a student.

Far more significant, of course, from the standpoint of the Institute in opposing taxation of the uncollected amounts is the fact that when the service contracts were signed, those amounts were not at all earned by the taxpayers' performance. For this reason there was no warrant for taxing the future payments as income when the contracts were signed.

*Commissioner v. Hansen*, 360 U.S. 446, the only case cited to the Court of Appeals below by the Commissioner in support of taxing the entire face amounts of the service contracts, is wholly inapposite.<sup>28</sup> In *Hansen* the accrual basis taxpayers had fully performed their obligations under contracts with customers—by delivery of vehicles that had been sold—and had accordingly earned all of the contract price. See *id.* at p. 448. For this reason it was of no significance for accrual accounting purposes that a part of the contract price was being held in reserve accounts for the taxpayers by their financing organizations and would not be paid to them in cash until subsequent tax years. The amounts held in reserve had been as much earned by

<sup>28</sup> Supplemental Memorandum for the Respondent on Remand to the Court of Appeals for the Eighth Circuit in *Schlude v. Commissioner* (pp. 6-8).

those taxpayers as the amounts actually paid in cash to them as down payments by car buyers and the amounts paid by the financing organizations, to whom the taxpayers sold the negotiable notes of the car buyers for the balance of the contract price. The conclusion was thus compelled that the *Hansen* taxpayers had a "fixed right to receive" the amounts they were seeking to postpone reporting as income, and under fundamental principles governing accrual accounting for tax purposes (see pp. 19-25 above) this was sufficient to subject those amounts to tax.

In *Schlude*, on the other hand, substantial portions of the contract amounts remained not only uncollected when the contracts were signed, but also remained unearned by the taxpayers until they performed the services the contracts called for.<sup>29</sup> Simply stated, the

<sup>29</sup> It would, of course, be equally improper to equate the situations of the taxpayers in the *Hansen* and *Schlude* cases merely because in both proceedings the taxpayers discounted with financing organizations all or part of long-term contracts on which amounts remained unpaid. See p. 3, n. 1 above. The fact that in both cases the financing organizations withheld a portion of the discounted value of the contract in a "reserve account" no more determines the tax year in which the *Schlude* taxpayers should have reported income than the fact that the bank actually paid them only 50 percent of the unpaid portion of the contract in cash immediately. The test in each instance should be: what portion of the cash payments and of the reserve accounts—like payments made by students to the taxpayers directly—was earned in any tax year.

The "services" rendered by the taxpayers in *Schlude*, moreover, were the essence of their business. They were thus unlike the incidental services (e.g., account collection, repossession of goods, repurchase of contracts defaulted) to which taxpayers comparable to those in *Hansen* have pointed in unsuccessful attempts to urge that part of the purchase price of goods had not been earned at the time of sale. See *General Gas Corp. v. Commissioner*, 293 F.2d 35, 40-41 (5th Cir. 1961), cert. denied, 369 U.S. 816; *Bruce Flournoy Motor Corp. v. United States*, CCH Trade Reg. Rep. ¶ 9695, at page 85,820 (E.D. Va. July 16, 1962).

uncollected amounts—like the advance receipts—were amounts that the *Schlude* taxpayers would have a “fixed right to receive” only as they performed services.

Such a “fixed right,” moreover, did not exist at the time the contracts were entered into merely because contract payments were ordinarily received prior to any performance by the taxpayers and at any point during the life of a particular contract such payments might or might not be greater in amount than the contract value of the services rendered by the taxpayers. A contract providing for payment prior to or unrelated in time to performance does not give the party obligated to perform in the future a fixed right either to retain prior payments or to receive future payments if he disables himself from performing or attempts to alter the performance required of him under the contract. 3A Corbin, *Contracts*, § 654 (1960 ed.); 3 Williston, *Contracts*, §§ 812, 830, 860 (1936 ed.); *Restatement, Contracts*, §§ 269-270; Patterson, E. W., *Constructive Conditions in Contracts*, 42 Colum. L. Rev. 903, 914, *et seq.* (1942). Under settled law, therefore, the *Schlude* taxpayers, as all other similar taxpayers who contract to perform services (or to produce goods) in subsequent tax years, were required to hold themselves in a position to perform in the manner that they had agreed as a condition to receiving and retaining payment.<sup>30</sup>

<sup>30</sup> Respondent has disclaimed taking the position “that an accrual basis taxpayer must accrue income whenever he signs a contract to perform services.” Urging what we believe to be an entirely outmoded argument of contract law concerning “dependent” and “independent” covenants, it has pointed to what it conceives of as the “seemingly unusual features” and the “atypical payment provisions” of the *Schlude* service contracts as an at-



Not only may no support be gleaned from the *Hansen* and *American Automobile* cases for the aspect of the decisions below dealing with the contract amounts that were both uncollected and unearned, but as a matter of simple justice it cannot be that such portions of the face amount of a service contract for a term of years may be taxed in their entirety as income in the year the contract is signed. Such a result is improper and arbitrary. It has no more justification than would the taxation at the face amount of all future interest coupons on a bond, or of all future rental under a lease, in the year in which the bond is purchased or the property leased. And it would compel accrual basis taxpayers to report as income amounts far in excess of what is demanded in comparable situations of cash basis taxpayers, who report in the tax year of receipt only the discounted fair market value of compensation paid to them in property other than cash.<sup>21</sup>

2. The improper extension of this Court's *American Automobile* decision by the Court of Appeals below to amounts not yet received would be remedied if this Court were to decide that the *Schlude* taxpayers' accrual accounting system is proper for tax purposes.

The taxpayers' accounting method in *Schlude* was as accurate in determining income in a tax year for

tempt to justify taxing their entire face amounts in the tax year in which the contracts were signed. See Brief for the Respondent in Opposition, *Schlude v. Commissioner*, pp. 11-12; No. 793, Supreme Court, 1961 Term. Respondent thus appears to have agreed that if its understanding of the applicable law of contracts is erroneous, its position that the *Schlude* taxpayers had a "fixed right to receive" the face amounts of the contracts in the tax year of signing is likewise in error.

<sup>21</sup> See Treas. Reg. § 1.61-2(d); see also Note, 48 Va. L. Rev. 731, 745-749 (1962).

the uncollected portions of the service contracts as it was for the portions as to which the taxpayers received advance receipts. Under the accounting procedures that were followed, the taxpayers simply reported all income precisely as it was earned under each contract through their performance of services in each tax year, without regard to whether cash amounts allocable to the taxpayers' performance might or might not have been in fact paid by a student. It was thus possible that the taxpayers would have reported income under a contract as to which they had performed more services than they had actually been paid for in cash. As we have noted (p. 21 above), this result is of course proper under accrual accounting, and can not be objected to by accrual basis taxpayers, for the reason that income in such a case has been "earned"—that is, properly accrued—by the taxpayer. The *Schlude* taxpayers' objection, therefore, and the concern of the Institute, is not merely that uncollected contract amounts should not be taxed in the tax year the contract is signed because the taxpayers have received no cash as to such amounts, but more importantly, that the uncollected amounts should not be taxed until the tax year in which the taxpayers' performance of services earns income.

**CONCLUSION**

For the foregoing reasons, the Institute urges that the decision of the Court of Appeals for the Eighth Circuit be reversed.

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# In the Supreme Court of the United States

OCTOBER TERM, 1962

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No. 80

MARK E. SCHULDE, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF  
APPEALS FOR THE EIGHTH CIRCUIT

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## BRIEF FOR THE RESPONDENT

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### PRIOR OPINIONS

The findings of fact and opinion of the Tax Court (R. 246-264) are reported at 32 T.C. 1271. The first opinion of the court of appeals (R. 278-291) is reported at 283 F. 2d 234. The *per curiam* order of this Court granting certiorari and remanding the case is reported at 367 U.S. 911. The order of this Court denying rehearing and amending the previous *per curiam* order is reported at 368 U.S. 873. The *per curiam* opinion of the court of appeals upon remand (R. 273-274) is reported at 296 F. 2d 721.

### JURISDICTION

The judgment of the court of appeals was entered on December 15, 1961. (R. 274-275.) The petition

for a writ of certiorari, filed on March 15, 1962, was granted on May 28, 1962. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

#### QUESTION PRESENTED

Whether the courts below correctly sustained the Commissioner's determination that an accrual basis taxpayer who contracts to furnish dancing lessons during a period extending beyond the close of the taxable year is required to accrue and report as gross income for the taxable year (a) cash and negotiable notes received in that year as an advance payment of the contract price, and (b) future installments contractually due in that year whether or not the "related" lessons have been taken.<sup>1</sup>

#### STATUTES AND REGULATIONS INVOLVED

The statutes involved are Sections 24(a), 22(a), 23(a)(1)(A), 23(e), 41, 42(a), 43, and 48(a) and (c), Internal Revenue Code of 1939; Sections 61, 63(a), 162(a), 165(a) through (c), 441(a) through (e), 446, 451(a), and 461(a), Internal Revenue Code of 1954. See Appendix, *infra*, pp. 69-76.

<sup>1</sup> The petitioners, husband and wife, are members of a partnership which operates a dance studio. Though a partnership is not a separate taxable entity, the partners being liable for income tax in their individual capacities (see 1939 Code, Sections 181-188; 1954 Code, Sections 701-706), for convenience, the petitioners are sometimes referred to in the singular as "the taxpayer" or "the Studio."

Three "taxable years" of the Studio (fiscal years 1952-1954) are involved, and, for convenience, reference is sometimes made to a single taxable year. Numerous individual contracts are also involved, and they are also sometimes referred to in the singular.



The Regulations involved are Treasury Regulations 118 (1939 Code), Sections 39.41-1, 39.41-2, 39.41-3, 39.41-4, 39.42-1(a), 39.42-4, 39.43-1(a), and 39.43-2; Treasury Regulations on Income Taxes (1954 Code), Sections 1.441-1, 1.446-1, 1.451-1(a), 1.451-3, and 1.461-1(a). See Appendix, *infra*, pp. 76-99.

#### STATEMENT

The taxpayers, husband and wife, formed a partnership in 1946 known as Arthur Murray Dance Studio (the "Studio"), for the purpose of giving dance instruction and operating studios under franchise agreements received from Arthur Murray, Inc., of New York City. The partnership operated studios in the States of Nebraska, Iowa and South Dakota. (R. 248-249.)

Basically, there were two kinds of contracts entered into between the Studio and students. Under one type, all of the down payment was made in cash at the time the contract was executed, with the balance of the contract price to be paid in installments. Under the other, a portion of the down payment was paid in cash at the time the contract was entered into, and the balance was to be paid in installments; the remainder of the contract price was evidenced by a negotiable note taken from the student, which was payable in designated installments. (R. 249-250.)

All the contracts provided that (1) the student would pay for lessons in a certain amount, (2) the student should not be relieved of his obligation to pay the agreed amount, (3) no refunds would be made,

and (4) the contract was noncancellable. They further provided for a specific number of hours of lessons ranging from 5 to 1,200, and some of the contracts were for lifetime courses under which, in addition to 1,200 specified hours, the student was entitled to two hours of lessons per month plus two parties a year for life. Although the contracts specified a period during which the lessons had to be taken, they did not schedule specific dates for the lessons, these being arranged from time to time as lessons were given. Under many of the contracts the period of instruction extended beyond the fiscal year in which the contract was made, but in such cases the period usually ended in the next fiscal year. (R. 250.)

Notes accompanying contracts were negotiated by the Studio with a local bank. The bank would deduct its interest charges, pay approximately 50 per cent of the balance of the note to the Studio, and set up a reserve account for the other 50 per cent which the Studio could not use until after the note was paid in full by the student. When the note was paid, the balance in the reserve account was transferred to the Studio's general bank account. (R. 250-251.)

Cash payments received directly from students, the amounts received at the time notes were transferred to the bank, and the amounts received when notes transferred to the bank were fully paid, were either deposited or credited to the Studio's general bank account without segregation from its other partnership funds. (R. 251.)

Although the contracts stated that they were noncancellable, some of them were in fact cancelled, ac-

counting for about 17% of the taxpayer's total sales (R. 256, 258), and the Studio frequently rewrote contracts to reduce the number of lessons and the total charge. Also, despite the fact that the contracts provided that no refund would be made, and despite the fact that the Studio discouraged refunds, occasionally a refund would be made on a canceled contract. (R. 251.)

When the partnership was organized in 1946, a complete double entry bookkeeping system was installed by a firm of certified public accountants, and an accrual system of accounting, with a fiscal year ending March 31, was employed. This accounting system was used continuously and consistently from the time the partnership was formed. Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract. (R. 251-252.)

The accounting method used by the Studio is shown in detail in the findings of the Tax Court. In substance, when a contract was entered into with a student, a "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and the number of hours of lessons taught multiplied by the contract rate per hour was then deducted from "deferred income" and credited to "earned income." The so-called "earned income" thus derived was reported as gross income on the Studio's tax return. (R. 252-253.)

Expenses were recorded and deducted in the fiscal year incurred except that royalties to Arthur Murray, Inc., and certain other items were recorded and deducted when paid (R. 252).

Additional gross income was reported by the Studio each year as "gains from cancellation" of contracts. The Studio would treat as canceled any contract which had been inactive for more than a year. Gain on a cancelled contract would be computed as the amount by which the "deferred income" account with respect to such contract exceeded the unpaid portion of the contract price, i.e. the amount received in advance for untaught lessons. (R. 253.)<sup>2</sup>

Schedules reflecting the Studio's system of accounting during the years in question (R. 253-256) show, *inter alia*, that the ending balances in its "deferred income" account were \$131,143.92, \$235,942.33, and \$248,740.30 for the fiscal years 1952, 1953, and 1954, respectively (R. 254). Of these ending balances, the aggregate amounts and percentages attributable to cash in hand,<sup>3</sup> plus funds held in the reserve account

<sup>2</sup> E.g., commissions to personnel for selling lessons (R. 218-219). Refunds were not recorded or claimed as separate items of deduction, but were charged to "deferred income", thereby reducing the "gains" ultimately reported from contract cancellations. (R. 220-221.)

<sup>3</sup> The Studio did not report any losses from cancellation during the years in question. (R. 256.)

<sup>4</sup> Denoted as "Deferred Income Collected." (R. 255.)

<sup>5</sup> Denoted as "Reserve Fund Held by Bank on Students Notes Financed." (R. 255.) On the original exhibit, from which the schedule was drawn, there were alternative computations the first of which treated the "Reserve Fund" separately, and the second of which treated it as part of "Deferred Income Collected." (Ex. 14-N; R. 145, 218-219.)

were \$67,516.69, or 52 per cent, for fiscal 1952; \$149,244, or 63 per cent, for fiscal 1953; and \$163,563.20, or 66 per cent, for fiscal 1954. (R. 255.) The remainder of the annual ending balance in the "deferred income" account was attributable to "Students Accounts Receivable" of \$63,627.23, or 48 per cent, for fiscal 1952; \$86,698.33, or 37 per cent, for fiscal 1953; and \$85,177.10, or 34 per cent for fiscal 1954. (R. 255.) "Students Accounts Receivable" was in turn comprised of "Installment Contracts Carried by Studio, Notes Not Yet Processed Through the Bank, and Unpaid Balances on Planned Cash Courses." (R. 255.)

The ordinary net income of the Studio, as reflected on its books and returns for the years in question, was computed in the following manner (R. 256):

	March 31, 1952	March 31, 1953	March 31, 1954
Gross Income			
Contract Aids transferred to Earliest Income	\$143,919.03	\$243,277.49	\$427,866.97
Gains from amortization	5,894.40	17,743.49	28,448.61
Other Income	4,011.21	17,428.23	19,987.31
Total	\$153,824.64	\$278,449.21	\$476,302.89
Deductions	137,287.91	233,390.49	301,000.29
Ordinary Net Income	\$16,536.73	\$45,058.72	\$175,002.60

A typical computation is as follows: For fiscal 1954, the sum of the ending balances of "Deferred Income Collected" (\$129,029.98) and "Reserve Fund" (\$34,533.22) is \$163,563.20. (R. 255.) This total is approximately 66 percent of the ending balance in the "deferred income" account (\$248,740.30). (R. 254.)

The record does not contain an arithmetical or percentage breakdown of the subsidiary items comprising "Students Accounts Receivable," nor does it show precisely how much of the overall ending balance in the "deferred income" account for each year derived from contracts entered into in that year as opposed to contracts entered into in a previous year (or years).

As appears from the above table, a substantial part of the "Ordinary Net Income" reported by the Studio in each year consisted of "gains from cancellation" rather than "Earned Income".

The Commissioner ruled that the Studio was required to report the entire amount of each contract as gross income for the year in which the contract was entered into. Accordingly, in his notices of deficiency he increased the ordinary net income of the partnership for each fiscal year by the amount of the increase in the "deferred income" account in that year, viz., \$24,602.22 for 1952, \$104,798.41 for 1953, and \$12,797.97 for 1954. (R. 256.) The Tax Court, three judges dissenting, sustained the Commissioner's determination. (R. 246-264.) The court of appeals, one judge dissenting, reversed the Tax Court. (R. 278-291.)

The Commissioner's petition for certiorari to review the court of appeals' decision was pending when this Court decided *American Automobile Assn. v. United States*, 367 U.S. 687. On the same day, the Court granted certiorari, vacated the judgment, and remanded the case to the court of appeals for reconsideration in the light of that decision. 367 U.S. 911; 368 U.S. 873. Upon reconsideration, after re-argument, the court of appeals vacated its prior judgment and affirmed the decision of the Tax Court. (R. 273-274.)

#### SUMMARY OF ARGUMENT

##### I. THE ADVANCE RECEIPTS

A. Deeply rooted in our taxing system is the axiom that the statutory "net income"—the difference be-



between the total amount of "gross income" items and the total amount of "deduction" items—must be computed and reported on an annual ("taxable year") basis, regardless of whether a particular contract or transaction which gives rise to the items of gross income and deduction spans more than one taxable year or ultimately produces a net profit or loss. As applied to a taxpayer reporting taxable income under the "accrual" method of accounting, as distinguished from the "cash" method, the annual accounting rule requires that an item of gross income (*e.g.*, compensation for services, gain from a sale, *etc.*) be reported in the taxable year when the right to receive it becomes fixed (irrespective of when it is receivable), which can be no later than the year in which the income is actually received under claim of right and without restriction as to its use. Conversely, an item of deduction (*e.g.*, expense, loss, *etc.*) may be offset against gross income only in the taxable year in which the taxpayer's liability to pay it becomes fixed (irrespective of when it is payable), which can be no later than the year in which it is actually paid without protest.

This Court has repeatedly held that a taxpayer who receives money under a claim of right and without restriction as to its disposition must report it as gross income in the year received—whether he employs the cash or the accrual method of accounting—even though he may become obliged to and does refund the income in a later year. Since an obligation to restore the very income received does not relieve the recipient of the duty to report the income in the year of receipt, an obligation to incur future expenses in consideration

of the income received surely does not suffice to do so. Only if and when the expenses of performance are *actually incurred*—i.e., only in the taxable year when the liability to pay becomes fixed in fact and amount—will an accrual basis taxpayer become entitled to deduct them.<sup>8</sup>

In so far as the advance receipts are concerned, the situation here is in all material respects the same as in *American Automobile Assn. v. United States*, 367 U.S. 687, which holds that compensation paid in advance for future services must be reported in the taxable year of receipt and may not be deferred until a later year in which the services are to be performed.

2. The Studio's accounting system violates the annual accounting rule and related accrual principles. By attempting to "match" against compensation currently received for future services "related costs" of future performance, the Studio in effect is seeking, in the guise of deferral of "unearned income", to reduce its actual gross income by a reserve for estimated future expenses—an accounting procedure specifically disapproved by this Court. The Studio ought not be permitted to accomplish indirectly, by way of exclusion from gross income, what it cannot do directly by way of deduction. Essentially the same "earned" income argument here advanced by the Studio and amicus was rejected by this Court in the *A.A.A.* case.

We have no quarrel with the Studio's contention (reiterated by the amicus curiae) that its system of accounting was in conformity with generally accepted commercial accounting practices. However, as this

Court has often held, commercial accounting methods are not determinative of proper accounting for federal income tax purposes. Accounting practices designed to reflect net income in reports to stockholders or creditors are not necessarily suited to the requirements of a tax system, and the meaning accorded "net income" by the accounting profession differs from its meaning as used in the Internal Revenue Code and consistently applied by this Court.

Far from supporting its contention, the cases upon which the Studio chiefly relies (*e.g.*, *United States v. Anderson*, 269 U.S. 422) support the decision below. They involved deduction items, and they hold that such items are deductible by an accrual basis taxpayer only in the taxable year in which all the events which fix the liability to pay have occurred—the so-called "all events" test. The "related costs" which the Studio is here attempting indirectly to deduct are expenses not yet incurred. As for the cases involving accrual of income upon which the Studio relies (*e.g.*, *Spring City Co. v. Commissioner*, 292 U.S. 182), they likewise support the Government's position. They stand for the proposition that gross income must be reported in the taxable year in which the taxpayer's right to receive it becomes fixed, and the opinions are to be searched in vain for any suggestion that one who receives advance payment for future services has no "right to receive" the amounts when received.

Finally, in harmony with the controlling decisions, the Regulations also embody the fixed "right to re-

ceive" test for the accrual of gross income items (and the correlative fixed "liability to pay" test for accrual of deduction items), and the Commissioner has expressly ruled that prepaid service income received under a claim of right and without restriction as to its use must be reported in its entirety in the year of receipt.

B. As this Court pointed out in *American Automobile Assn.*, as an independent ground for its decision (367 U.S. at 694-697), Congress has evinced an unmistakable intention to endorse the long-standing view of the Commissioner and the courts precluding deferral of income received in one taxable year for services to be performed in a later year. This is demonstrated by the legislative history surrounding the enactment and repeal of 1954 Code, Sections 452 and 462, dealing respectively with deferral of prepaid income and deductions of reserves for estimated expenses. And it is confirmed by the history of recent legislation (1954 Code, Sections 455 and 456) authorizing, with carefully specified safeguards and limitations, only designated classes of taxpayers (publishers of periodicals and certain membership corporations) to defer prepaid income. These indications, together with the unsuccessful career of several bills designed to permit income-deferral by other classes of taxpayers, show that Congress is aware of the problem which this case presents and has it under continuing study. In *American Automobile Assn.* the Court expressly refrained from carving out exceptions to the annual accounting rule and corollary accrual principles which Congress itself

has not seen fit to create—a course made particularly desirable by “the complications inherent in the problem and its seriousness to the general revenue” (367 U.S. at 697). The same considerations, we submit, counsel a similar course here.

C. In any event, the accounting system used by the Studio is artificial, and must, for that reason, be rejected.

## II. THE FUTURE INSTALLMENTS

With respect to the unreceived portion of the contract price—the future installments—we acknowledge that it was error for the Commissioner to treat the entire amount as having accrued at the time the contract was executed. The “right to receive” a future installment became fixed on either of the following dates, whichever arrived earlier: (1) when the services for which the installment was payable were rendered, or (2) when the installment payment became due under the contract. The case should be remanded for a determination, under this test, of how much of the unreceived portion of the contract price accrued within each taxable year.

## ARGUMENT

### INTRODUCTION

The taxpayers, members of a partnership operating a dance studio, entered into contracts with students to furnish a specified number of dancing lessons on dates to be arranged by the student. Part of the contract price was paid in cash (or negotiable notes) at the time the contract was executed, and the balance was payable in installments on fixed dates which bore no

relationship<sup>9</sup> to the dates lessons were to be given. Under the terms of the contract the Studio had a right to receive, and did in fact receive, most of the contract price in advance of furnishing lessons.<sup>10</sup> In many instances, the Studio was never called upon to furnish all the lessons contracted for, and after a waiting period it cancelled the contract without refunding the advance payment. The Studio prorated the contract price according to the number of lessons to be furnished under the contract, and in its federal income tax returns (filed on the fiscal year-accrual basis) it reported as gross income for the taxable year only the portion it attributed to lessons given during that year. It treated the balance as "deferred" or "unearned" income, reportable in a subsequent taxable year in which the remaining lessons were to be given or in which the contract was cancelled.<sup>11</sup> Both courts below agreed

<sup>9</sup> The record does not contain a contract by contract breakdown of receipts *vis-a-vis* accounts receivable. However, as pointed out in the Statement (*supra*, pp. 6-7), approximately 50 to 60 per cent of the annual ending balance in the Studio's "deferred income" account for each fiscal year represented amounts actually received in cash and negotiable notes on contracts entered into during the year, and the remaining 40 to 50 per cent represented accounts receivable due in the following year (one year). We assume, in the absence of any contrary proof by taxpayer, that these overall percentages are an accurate reflection of the percentages applicable to each individual contract.

<sup>10</sup> The Studio's method of accounting may be illustrated by the following example given by the Tax Court (R. 257):

On August 1, 1952, the Studio enters into a contract with a student whereby the Studio agrees to teach the student 24 1-hour dancing lessons and the student agrees to pay \$240 therefor, \$100 down and \$20 per month for the next 7 months. (In some cases the student gives a negotiable



with the Commissioner that the Studio's method of accounting did not clearly reflect its annual taxable income, and that the Studio was required to report the full contract price as gross income for the taxable year in which the contract was executed.

The tax accounting problem presented divides itself into two parts: (1) includability in the Studio's gross income for the taxable year of the portion of the contract price received in that year in cash or negotiable notes pursuant to the terms of the contract,<sup>10</sup>

note for the installment payments.) Lessons are arranged from time to time and at the end of 1952 the Studio has given the student 10 lessons and the student has paid \$180, the \$100 down and four \$20 installments. By March, 1953, the Studio gives the student 10 additional lessons and the student pays \$40, two more installments. The student loses interest in the course and does not take the remaining four lessons and the Studio is unable to collect the remaining \$20.

In 1952 the Studio, which reports on an accrual basis, returns as gross income \$100, representing 10 lessons taught at \$10 per lesson. During 1953 the Studio returns as gross income \$100 representing 10 lessons taught at \$10 per lesson. After the contract has been inactive for a year the Studio cancels it, computing a gain or loss thereon. Here the gain would be \$20. (Four lessons untaught at \$10 per lesson equals \$40, less contract price unpaid of \$20 equals \$20 gain). This \$20 gain on cancellation would be returned as gross income in 1954.

<sup>10</sup> In many instances, the Studio received (in addition to cash) negotiable notes, which it negotiated with a bank. After deducting interest charges the bank paid approximately 50 per cent of the amount of the note to the Studio, and credited the other 50 per cent to a reserve account which was transferred to the Studio's general bank account when the note was paid by the student. (R. 250-251.) The 50 per cent received by the Studio in cash from the bank manifestly falls in the same category as the cash received by it directly from students.

for lessons to be furnished after the close of the year (Point I, *infra*): (2) includability of the balance of the contract price receivable in future installments (Point II, *infra*).

With respect to the advance receipts, the issue here is essentially the same as in *American Automobile Assn. v. United States*, 367 U.S. 687, rehearing denied, 368 U.S. 890, namely, whether an accrual basis taxpayer may postpone the reporting of compensation received in one taxable year for services to be rendered in a later year, so as to "match" and offset

As for the other 50 per cent credited to the Studio by the bank in the reserve account, since the Studio had a fixed right to receive the amount credited when the note was paid by the student, subject only to its contingent liability as guarantor, for tax accounting purposes this amount likewise falls in the same category as the cash receipts. See *Commissioner v. Hansen*, 360 U.S. 446; *General Gas Corp. v. Commissioner*, 293 F. 2d 35 (C.A. 5th), certiorari denied, 369 U.S. 816; *Shapiro v. Commissioner*, 295 F. 2d 306 (C.A. 9th), certiorari denied, 369 U.S. 829. The reserve account is indistinguishable from the cash receipts for present purposes for the additional reason that there has been no showing that the fair market value of the notes when received was less than the total amount (cash paid plus reserve credited) at which they were discounted by the bank. See Section 39.22(a)-4 of Regulations 118 under the 1939 Code; Section 1.61-2(d) (1) and (4) of the Regulations under the 1954 Code; *Bratton v. Commissioner*, 283 F. 2d 257 (C.A. 6th), affirming 31 T.C. 891; *Kitrell v. United States*, 79 F. 2d 259, 262 (C.A. 10th), certiorari denied, 296 U.S. 643; cf. *Pinellas Ice Co. v. Commissioner*, 287 U.S. 462, 468-469. At any rate, neither the Studio nor the amicus raises any separate question as to the treatment of the notes for purposes of this case, and we suggest the Court may treat them on the same footing as the cash receipts, without resolving the question.

against the amount received "related" service expenses which the taxpayer expects to incur in the later year. It is the Commissioner's position (1) that *any* method of accounting which defers the reporting of compensation actually received in one taxable year constitutes a clear departure from the annual accounting rule and corollary accrual principles consistently applied by this Court in federal income tax cases; (2) alternatively, even assuming (as the Studio and amicus curiae contend) that the AAA decision is to be construed as sanctioning the use for federal income tax purposes of a deferral-of-prepaid-income method of accounting which is not "artificial", nevertheless the particular method which the Studio here employed is artificial and, accordingly, was properly rejected.

With respect to the balance of the contract price receivable in future installments, we agree with the Studio that it was not required to accrue the installments at the time the contract was executed, as originally determined by the Commissioner. In our view, the Studio acquired a fixed right to receive the installment payments when it furnished the lessons for which the installments were payable, or when the stipulated time for payment of the installment arrived, whichever date was earlier. Accordingly, we consent to a remand of the case for the purpose of allocating the correct portion of the deferred contract price, on this basis, to each of the taxable years involved.

## 1. THE ADVANCE RECEIPTS

THE STUDIO'S METHOD OF ACCOUNTING, DEFERRING THE ACCRUAL AND REPORTING OF COMPENSATION RECEIVED IN THE TAXABLE YEAR IN ORDER TO REFLECT RELATED SERVICE EXPENSES TO BE INCURRED IN A LATER YEAR, WAS PROPERLY REJECTED BY THE COMMISSIONER AND BOTH COURTS BELOW AS VIOLATING SETTLED TAX ACCOUNTING PRINCIPLES

*A. The Studio's transactional method of accounting does not reflect its taxable net income for each taxable year*

1. Under the annual accounting rule and related accrual principles gross income items must be reported in the taxable year in which the right to receive them becomes fixed, and deduction items in the year in which the liability to pay them becomes fixed.

Sections 11 and 12 of the Internal Revenue Code of 1939 impose a tax on the "net income" of individuals and corporations, respectively.<sup>11</sup> Section 21 (Appendix, *infra*, p. 69) defines "net income" as the "gross income" less allowable "deductions". Section 22(a) (Appendix, *infra*, p. 69) defines gross income as including compensation for services, and Sections 23 (a)

<sup>11</sup> The deficiencies in controversy are for the calendar years 1952, 1953 and 1954, i.e., the taxable years of the individual partners. The taxable years of the partnership, used for information purposes only, are the fiscal years ended March 31, 1952, March 31, 1953, and March 31, 1954. Where the taxable year of a partner is different from that of the partnership, the partner includes in his annual return the share of partnership net income attributable to him for the taxable year of the partnership ending within his own taxable year. Section 188, Internal Revenue Code of 1939, Section 706, Internal Revenue Code of 1954. With respect to the first two of the three years involved, the 1939 Code and Treasury Regulations 118 apply. The comparable provisions of the 1954 Code and implementing Treasury Regulations, which apply to the third year, are substantially the same in all material respects, although more explicit.

and (e) (Appendix, *infra*, pp. 69-70) respectively authorize the deduction of ordinary and necessary business expenses "paid or incurred during the taxable year" and "losses sustained during the taxable year." Sections 41, 42(a), and 43 (Appendix, *infra*, pp. 70-71) require net income to be computed and reported upon the basis of an "annual accounting period" (the "taxable year"); in accordance with the method of accounting regularly employed by the taxpayer, provided such method clearly reflects the net income for the taxable year." See also section 48 (Appendix, *infra*, p. 71); Sections 39.41-1, 39.41-2, 39.41-3, 39.41-4, 39.42-4, 39.43-1, 39.43-2 of Regulations 118 under the 1939 Code (Appendix, *infra*, pp. 76-83).<sup>12</sup>

For federal income tax purposes, as this Court has frequently noted, the two principal recognized accounting systems are the "cash" and "accrual" methods. Under the cash method, gross income is reported in the taxable year of actual receipt and deductions are taken in the year of actual expenditure. Under the accrual method, gross income items are reported in the year in which the right to receive them becomes fixed, even though they are not immediately receivable, but no later than the year of actual receipt; conversely, deduction items are reported in the year in which they are incurred, i.e., when the liability to pay becomes fixed in fact and

<sup>12</sup> The comparable provisions of the 1954 Code are Sections 61, 63, 162, 441, 446, 451, and 461 (Appendix, *infra*, pp. 72-76), and the comparable provisions of the Treasury Regulations under the 1954 Code are Sections 1.441-1, 1.446-1, 1.451-1, 1.461-1 (Appendix, *infra*, pp. 83-99).

reasonably ascertainable in amount, even though payment is not then due, but no later than the year of actual payment. Whichever method is adopted must of course be applied consistently. *Security Mills Co. v. Commissioner*, 321 U.S. 281; *Spring City Co. v. Commissioner*, 292 U.S. 182; *Commissioner v. Hansen*, 360 U.S. 446; *American Automobile Assn. v. United States*, 367 U.S. 687; *Brown v. Helvering*, 291 U.S. 193; *United States v. Anderson*, 269 U.S. 422; *Dixie Pine Co. v. Commissioner*, 320 U.S. 516.<sup>13</sup>

The cardinal rule, embodied in 1939 Code Sections 41-43 and repeatedly affirmed by this Court, is that taxable net income must be computed on an annual ("taxable year") basis, whether the cash or the accrual method is selected. Neither income nor deduction items may be accelerated or postponed from one taxable year to another in order to reflect the long-term economic result of a particular transaction or group of transactions. *Security Mills Co. v. Commissioner*, *supra*; *Spring City Co. v. Commissioner*, *supra*; *Dixie Pine Co. v. Commissioner*, *supra*; *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359; *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493; *Heiner v. Mellon*, 304 U.S. 271; *Lewyt Corp v. Commissioner*,

<sup>13</sup>Cf. *United States v. Consolidated Edison Co.*, 366 U.S. 380, reaffirming these general principles, but holding—on "the very narrow issue" involved (p. 387)—that the remittance of real estate taxes under protest, in accordance with the only method provided by state law for contesting their validity without risk of penalties or seizure and sale of the property, did not constitute a "payment" sufficient to require accrual of the taxes as a deduction in a year prior to the year in which the contest was finally resolved.



349 U.S. 237. As this Court said in *Security Mills, supra* (pp. 286-287):

The rationale of the system is this: "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income, and apply methods of accounting, assessment, and collection capable of practical operation." [Quoting from *Burnet v. Sanford & Brooks Co.*, 282 U.S. at 363.]<sup>14</sup>

<sup>14</sup> In *Sanford & Brooks* the Court rejected the taxpayer's contention that compensatory damages received in one year under a construction contract could be matched against expenses incurred in a prior year under the contract, in order to arrive at the taxable income. Holding that the amounts received were includible in gross income in the year of receipt, Mr. Justice Stone stated, 282 U.S. at 363-365:

All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fixed year which he may adopt. Under §§ 230, 232 and 234 (a) of the Revenue Act of 1918, 40 Stat. 1057, respondent was subject to tax upon its annual net income, arrived at by deducting from gross income for each taxable year all the ordinary and necessary expenses paid during that year in carrying on any trade or business, interest and taxes paid, and losses sustained, during the year. \* \* \*

A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of

This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, *or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.*

But the petitioner urges that § 43 has altered the rule, so that a hybrid system, partly annual and partly transactional, may, within administrative discretion, be substituted for that of annual accounting periods. It urges that the change was due to the desire of Congress to prevent distortion of true income. This must mean distortion of true income, not of a given year, but, in the light of ultimate gain, from a series of transactions over a period of years, growing out of, or in some way related to, an initial transaction in the taxable year. The very section on which petitioner relies, however, reiterates the adherence of Congress to the system of annual periods of computation. [Emphasis added.]

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a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if it were practicable. It would not necessarily obviate the kind of inequalities of which respondent complains. • • •

The taxpayer in *Security Mills*, reporting on the accrual basis, had included in gross income for 1925 certain processing taxes which it had collected as part of the sales price of flour sold to customers. Concurrently, in order to reflect the fact that, though contesting the constitutionality of the tax, it had in fact paid the amounts collected into a depository in a suit to enjoin their payment over to the Government, the taxpayer claimed the taxes as a deduction from gross income. Applying the annual accounting rule and related accrual concepts, the Court sustained the Commissioner's disallowance of the deduction. The result undoubtedly would have been no different had the taxpayer, instead of reporting the amount in question as gross income and currently claiming it as a deduction, merely attempted (as does the taxpayer here) to exclude the amount from gross income by "deferring" its accrual.

In *Spring City Co. v. Commissioner*, 292 U.S. 182, a taxpayer filing its returns on the accrual basis sold goods on open account to a vendee which became insolvent during the taxable year of the sale. This Court held that the taxpayer could not defer reporting the account receivable as gross income in the year of sale in order to reflect the related bad debt loss resulting from the vendee's bankruptcy, since the "right to receive" the sale price from the vendee became "fixed" during the taxable year, whereas the related loss was not incurred and deductible until a later year. Mr. Chief Justice Hughes stated (pp. 184-185):

Petitioner first contends that the debt, to the extent that it was ascertained in 1920 to be worthless, was not returnable as gross income in that year, that is, apart from any question of deductions, it was not to be regarded as taxable income at all. We see no merit in this contention. Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. \* \* \* [Italics the Court.]

\* \* \* \* \*

If such accounts receivable become uncollectible, in whole or part, the question is one of the deduction which may be taken according to the applicable statute. See *United States v. Anderson*, 269 U.S. 422, 440, 441; *American National Co. v. United States*, 274 U.S. 99, 102, 103; *Brown v. Helvering*, 291 U.S. 193, 199; *Rouss v. Bowes* 30 F. (2d) 628, 629. That is the question here. *It is not altered by the fact that the claim of loss relates to an item of gross income which had accrued in the same year.* [Emphasis added.],

The reasoning which led this Court in *Spring City* to hold that a "loss" which had not been actually incurred during the taxable year did not warrant postponement of accrual of a related item of gross income applies with equal force to related income and "expense" items. Here, as in *Spring City Co.*, the question "is one of the deduction which may be taken according to the applicable statute," and that question "is not altered by the fact that the claim of loss [here, expense] relates to an item of gross income which had

accrued in the same year." Treating the issue as one of deduction rather than as one affecting the accrual of gross income, it is clear that anticipated losses may not be deducted under Section 23(a) until they are in fact "sustained", and that similarly anticipated expenses may not be deducted under Section 23(a) until they are in fact "incurred." They may not be accounted for in advance by postponing the return of gross income items to which they "relate." See also *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493; *Lucas v. American Code Co.*, 280 U.S. 445; *Brown v. Helvering*, 291 U.S. 193.

In *Brown v. Helvering*, *supra*, the Court held that a taxpayer filing his returns on the accrual basis was not entitled to deduct from gross income (insurance commissions) received in the taxable year an amount which his experience indicated would have to be refunded on account of policy cancellations, since his liability to repay was contingent, not fixed and absolute in that year. The Court stated (p. 199):

Under the Revenue Acts taxable income is computed for annual periods. If the accounts are kept on the accrual basis the income is to be accounted for in the year in which it is realized even if not then actually received; and the deductions are to be taken in the year in which the deductible items are incurred. \* \* \*

The Studio in effect is here attempting to accomplish what this Court in *Brown* held was not permissible—to offset against gross income for the taxable year an estimated amount of expense liabilities not yet incurred. While it seeks to exclude (and

fer") an estimated amount from gross income, instead of deducting it therefrom (as in *Brown*), the net result, from the tax standpoint, is the same under either method. As Congress recognized when it repealed Sections 452 (deferral of prepaid income) and 462 (accrual of estimated expenses) of the 1954 Code, "if section 452 is not repealed at the same time section 462 is repealed, a number of taxpayers who have reported a greatly reduced tax liability by electing the benefits of section 462 would be able to accomplish the same result by electing to defer income under section 452." H. Rep. No. 293, 84th Cong., 1st Sess., p. 4 (1955-2 Cum. Bull. 852, 854-855).<sup>15</sup>

Recent decisions of this Court have continued to sustain the application of the annual accounting rule to both accrual basis and cash-basis taxpayers despite its sometimes inequitable results.<sup>16</sup> Thus in *Lewyt Corp. v. Commissioner*, 349 U.S. 237, it was stated (p. 242) that "the concept 'accrued' embodies the an-

<sup>15</sup> Indeed, the impact upon the revenues of the deferral of gross income is even greater than the accrual of estimated expenses, since included in the gross income deferred is an element of profit which will be taxed, if at all, only in a later year when returned as "earned income" or "gains from cancellations." On the other hand, if future expenses are presently estimated and deducted, the profit element would at least be taxed in the year the income is received. Both methods, however, fail to satisfy the annual accounting requirement and may be rejected by the Commissioner.

<sup>16</sup> In *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 386, the Court observed that the special net operating loss carryover and carryback provisions of the statute (not applicable here) were enacted "to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis \* \* \* and to strike something like an average taxable income computed over a period longer than one year."



annual accounting principle," and that the settled meaning of that term would be effectively vitiated if an accrual basis taxpayer were permitted to take "events after the taxable year \* \* \* into account." In *United States v. Consolidated Edison Co.*, 366 U.S. 380, 384, it was regarded as "settled that each 'taxable year' must be treated as a separate unit, and all items of gross income and deductions must be reflected in terms of their posture at the close of such year." In *United States v. Lewis*, 340 U.S. 590, the Court stated (p. 592) "Income taxes must be paid on income received (or accrued) during an annual accounting period." In *Healy v. Commissioner*, 345 U.S. 278, it reiterated (pp. 284-285): "Congress has enacted an annual accounting system under which income is counted up at the end of each year \* \* \*. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed." And in *American Automobile Assn. v. United States*, 367 U.S. 687, which we submit is dispositive of the instant case with respect to the advance receipts, the Court concluded (p. 692) that the taxpayer's system of accounting "fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner."<sup>17</sup>

<sup>17</sup> In harmony with this Court's decisions, the clear weight of authority in the court of appeals, and the uniform authority in the Tax Court, has required adherence to the annual accounting rule in a variety of contexts. See, e.g., *Spencer, White & Prentiss v. Commissioner*, 144 F. 2d 45 (C.A. 2d), affirming 1943 P-H T. C. Memorandum Decisions, par. 43,306, certiorari denied, 323 U.S. 780; *Automobile Club of New York v. Commissioner*, 304 F. 2d 781 (C.A. 2d); affirming 32 T.C.

It is settled, as a familiar corollary of the annual accounting rule, that a taxpayer (whether on the

906; *Streight Radio and Television, Inc. v. Commissioner*, 280 F. 2d 883 (C.A. 7th), affirming 33 T.C. 127, certiorari denied, 366 U.S. 965; *Capital Warehouse Co. v. Commissioner*, 171 F. 2d 395 (C.A. 8th), affirming 9 T.C. 966; *South Dade Farms v. Commissioner*, 138 F. 2d 818 (C.A. 5th), affirming 1942 P-H B.T.A. and T.C. Memorandum Decisions, par. 42,516; *Clay Sewer Pipe Ass'n v. Commissioner*, 139 F. 2d 130 (C.A. 3d), affirming 1 T.C. 529; *New Capital Hotel v. Commissioner*, 261 F. 2d 437 (C.A. 6th), affirming *per curiam* 28 T.C. 706; *New Jersey Automobile Club v. United States*, 181 F. Supp. 259 (C. Cls.), certiorari denied, 366 U.S. 964; *Automobile Club of Southern California v. United States*, 5 A.F.T.R. 2d 901 S.D. Cal. 1960), appeal dismissed (C.A. 9th) November 28, 1961; *Sandegren v. Commissioner*, decided January 30, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,016; appeal pending (C.A. 9th); *Andrews v. Commissioner*, 23 T.C. 1026; *Your Health Club, Inc. v. Commissioner*, 4 T.C. 385; *Pioneer Automobile Service Co. v. Commissioner*, 36 B.T.A. 213.

The only cases of which we are aware that might be viewed as departures from the principles of annual tax accounting are *Beacon Publishing Co. v. Commissioner*, 218 F. 2d 697 (C.A. 10th), reversing 21 T.C. 610; *Schuessler v. Commissioner*, 230 F. 2d 722 (C.A. 5th), reversing 24 T.C. 247; and *Bressner Radio, Inc. v. Commissioner*, 267 F. 2d 520 (C.A. 3d), reversing 28 T.C. 378; cf., *Harrold v. Commissioner*, 192 F. 2d 1002 (C.A. 4th), reversing 16 T.C. 134; *Pacific Grape Prod. Co. v. Commissioner*, 219 F. 2d 862 (C.A. 9th), reversing 17 T.C. 1097. Of these, the *Bressner* case was effectively overruled, and the *Beacon Publishing Co.* and *Schuessler* cases were distinguished on their facts, in *American Automobile Ass'n. v. United States*, 367 U.S. 687, pp. 689, 691, note 4. We share the Tax Court's view (*Andrews v. Commissioner*, 23 T.C. 1026, 1033; *Automobile Club of New York v. Commissioner*, 32 T.C. 906, 912) that *Beacon Publishing Co.* and *Schuessler* were erroneously decided. This Court has expressly refrained from endorsing them as correct. See *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 189, note 20. In any event, as pointed out below, they are distinguishable from the present

case for the same reasons they were distinguished in *American Automobile Assn., supra*, p. 691, note 4.

cash or accrual basis) who receives income under a claim of right and without restriction as to its use must report it in the year received, even though he may later be required to restore the income. *North American Oil v. Burnet*, 286 U.S. 417; *United States v. Lewis*, 340 U.S. 590; *Healy v. Commissioner*, 345 U.S. 278; see also *Security Mills Co. v. Commissioner, supra*. In the *Lewis* and *Healy* cases it was held that a taxpayer who received money under a mistaken or invalid claim, and became obliged in a later year to refund part of it, was nonetheless required to report the full amount received in the year of receipt because the money had been received under a claim of right and was treated by the taxpayer as belonging to him. The Court stated in *Healy* (345 U.S. at 282-285):

The phrase "claim of right" is a term known of old to lawyers. Its typical use has been in real property law in dealing with title by adverse possession, where the rule has been that title can be acquired by adverse possession only if the occupant claims that he has a right to be in possession as owner. The use of the term in the field of income taxation is analogous. There is a claim of right when funds are received and treated by a taxpayer as belonging to him. The fact that subsequently the claim is found to be invalid by a court does not change the fact that the claim did exist. A mistaken claim is nonetheless a claim, *United States v. Lewis*, 340 U.S. 590 (1951):

The inequities of treating an amount as income which eventually turns out not to be income are urged upon us. \* \* \* Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made, and would violate the spirit of the annual accounting system. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed.

\* \* \* \* \*

The so-called "claim of right doctrine" and its rationale lend strong support to the government's position. Since the annual accounting rule requires a taxpayer who receives income under a claim of right and without restriction as to its use to report it in the year received, notwithstanding that he may later be required to *refund* the very income received, it would seem to follow that a taxpayer must report income in the year received even though he may later be required to *use* some or all of it to meet alleged "related" expenses. See *Streight Radio and Television, Inc. v. Commissioner*, 280 F. 2d 883 (C.A. 7th), affirming 33 T.C. 127, certiorari denied, 366 U.S. 965; *Spencer, White & Prentiss v. Commissioner*, 144 F. 2d 45 (C.A. 2d), affirming 1943 P-H T.C. Memorandum Decisions, par. 43,306, certiorari denied, 323 U.S. 780; *South Dade Farms v. Commissioner*, 138 F. 2d 818 (C.A. 5th), affirming 1942 P-H B.T.A. and T.C.

was includable in gross income in the year of receipt. Expressly recognizing a conflict with *Bressner Radio, Inc. v. Commissioner*, 267 F. 2d 520 (C.A. 2d), involving a similar method of accounting with respect to prepaid income for service guaranties, this Court granted certiorari and affirmed. It pointed out (pp. 690-692) that while the taxpayer's accounting method had been regularly and consistently employed, and was also in accord with generally accepted commercial accounting practices, it "fails to respect the criteria of annual tax accounting" required by the taxing statute, and, moreover, was "artificial" since rendition of the service was contingent upon members' demands. As a separate and independent ground for its decision, the Court pointed (pp. 694-697) to pertinent legislative history showing that Section 452 of the 1954 Code (dealing with "prepaid income") expressly authorized the very method of accounting employed by the taxpayer, but that Congress retroactively repealed the section and has subsequently refused to re-enact it despite repeated efforts to reinstate the repealed provisions.

The Studio (Br. 18-20) and amicus (Br. 12-14) attempt to distinguish A.A.A. on the theory that the Association could not demonstrate that its method of accounting "precisely matched" receipts against estimated future "related costs" of performing services, since the services there contracted for were to be rendered upon demand and were therefore uncertain and contingent, whereas here the contracts called for a specific number of lessons and the Studio's method

did "accurately match" its receipts against estimated related future service expenses."

It is true that the Court, both in *AAA* and its predecessor, *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, pointed to the contingent nature of the services as a factor making the method of deferral used "artificial". Additionally, the Court distinguished *Beacon Publishing Co. v. Commissioner*, 218 F. 2d 697 (C.A. 10th), and *Schuessler v. Commissioner*, 230 F. 2d 722 (C.A. 5th), on the ground that in those cases the taxpayer was required "to furnish services at specified times in years subsequent to the tax year" while, in the case of the automobile clubs, "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year" (353 U.S. at 189, n. 20; 367 U.S. at 691, n. 4). Even assuming, however, that the *AAA* decision leaves open the validity of such a distinction, this case would fall on the *AAA*, rather than the *Beacon Publishing*, side of the line. While the contracts were nominally for a stated number of dance lessons to be given within

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<sup>18</sup> It is anomalous to speak, as do the Studio and Amicus throughout their briefs, of an accounting system which "accurately and precisely matches" income currently received for future services with "related costs of [future] performance". The "related costs" which they would "match" against a current year's income consist of nothing more than a *presently estimated amount of future service expenses* to be incurred in a subsequent year. An income-deferral system based upon matching current income with estimated yet-to-be incurred expenses may hardly be dignified as an "accurate and precise" accounting system.



stated time limits, the services were not to be performed, as in *Beacon* and *Schuessler*, at "fixed dates" in the future but only as and when demanded by the student. Nor is that a merely formal distinction, for the Studio's experience has been that a large proportion of the lessons contracted for are never taken, with the result that its actual performance under any individual contract is in fact uncertain and contingent. As we have stated, a substantial number of the contracts were cancelled when the student failed to appear for a year, others were renegotiated for a lesser number of lessons, and, presumably, individual lessons were skipped without any adjustment. While the automobile clubs' per-month method of accrual was at least consistent with their actual group experience, the Studio's per-lesson method of accrual (based on the false assumption that all lessons contracted for will be taken) is contradicted by its own experience.

More importantly, however, we do not believe that the AAA decision can be limited, as the Studio and *amieus* would limit it, to cases in which the services to be performed are uncertain. Under the annual accounting requirement and related accrual concepts, compensation must be reported as gross income in the taxable year in which the right to receive it becomes fixed (in this case the year in which it was collected under claim of right and without restriction as to its use), and may not be diminished by a "matching" amount of estimated future service expenses which the

recipient admittedly has not yet incurred but merely expects to incur in a later year.<sup>19</sup>

Furthermore, the distinction which the Studio and amicus seek to draw between AAA and this case does not meet the second and independent ground for decision in AAA. Pointing to "other considerations requiring our affirmance" (367 U.S. at 694), the Court went on to demonstrate, from the history of the 1954 Code and its amendments dealing with the income-deferral problem, affirmative Congressional endorsement of the view long held by the Commissioner and the courts disallowing the deferral of income for tax purposes.<sup>19a</sup> From that demonstration the Court concluded that it should follow the established administrative and judicial practice barring deferral and leave to Congress the carving out of appropriately limited exceptions, a course made particularly desirable by "the complications inherent in the problem and its seriousness to the general revenue" (367 U.S. at 697). Whatever may be said of the implication of the first part of the opinion, there is nothing in the rationale of the latter part by which to confine it to contingent-service contracts. That ground of the decision is applicable to *any* method of deferral of prepaid service income—whether the services are to be rendered on certain or uncertain dates in the future—and was properly found to be controlling by the courts below.

<sup>19</sup> See Costelloe, "Con Edison and AAA cases seen as landmarks in the law of tax accounting", 15 J. Taxation 216 (October 1961).

<sup>19a</sup> See, e.g., the passage from the Senate Report quoted at 367 U.S. 694-695, note 8, reproduced *infra*, pp. 58-59, note 36.

2. The Studio's accounting system violates the annual accounting rule and related accrual principles.

(a) *The transactional or "earned income" method of accounting urged by the Studio.*—The Studio's method of accounting, on its face, fails to satisfy the annual accounting requirement and related accrual concepts. Instead of accruing and reporting as gross income in each taxable year the entire amount of compensation received in that year, and deducting only expenses actually incurred and losses actually sustained in the same year, the Studio has excluded ("deferred") from gross income all payments assumed to be "related" to future service expenses. This deferral of items of gross income currently received in order to reflect estimated items of deduction not yet incurred cannot be squared with the injunction in *Security Mills* (321 U.S. at 286-287) against "allocating income or outgo to a year other than the year \* \* \* in which the right to receive, or the obligation to pay, has become final and definite in amount." Far from clearly reflecting its "net income" for a single "taxable year" on the basis of gross income actually accrued and expenses actually incurred within that year, as demanded by the statute and this Court's decisions, the Studio's returns purported to reflect the net result of its service contracts over a period of two or more taxable years (indeed, over a lifetime in the case of life contracts).

In advocating approval of its method of accounting, the Studio and amicus misconceive the fundamental tax accounting principles which they purportedly accept. Contrary to their assumption, in

determining taxable income for a given taxable year on the accrual method it is immaterial whether gross income and deduction items enumerated in the taxing statute stem from the same contract or are otherwise transactionally "related." The only relevant question is whether the taxpayer had a fixed "right to receive" the gross income item or a fixed "liability to pay" the deduction item within the taxable year. Insofar as they appear to accept the correct test, petitioner and amicus escape the normal result only by making an assumption contrary to fact and inventing a rule of law which finds no support in the statute, Treasury Regulations, or the controlling decisions. The fact assumed is that the Studio had no fixed "right to receive" the advance payments for services at the times it did receive them; the rule supposed is that a "right to receive" payment in no event arises until the services are performed, *i.e.*, when the related service expenses are incurred.

The first premise fails to distinguish between the absolute right, accorded the Studio by the terms of its service contracts, to receive compensation in advance of performance (which gives rise to accrual of the compensation), and a contingent obligation to refund all or part of the prepaid compensation in the event it failed to perform (an event which would give rise to a deductible loss for breach of the contract).<sup>20</sup>

<sup>20</sup> Even in such event, the loss would not be deductible on the accrual basis until the year in which the liability for the damages became fixed. See *Lucas v. American Code Co.*, 280 U.S. 445, where the Court said (p. 450): "Obviously, the mere refusal to perform a contract does not justify the deduction, as a loss, of the anticipated damages." Similarly, the mere

While the right to receive normally precedes actual receipt, it can arise no later than the time the taxpayer *actually receives* the income under a claim of right and treats it as his own. Indeed, there is no better evidence of a fixed right to receive income than its receipt under claim of right, coupled with its unrestricted use by the recipient. One who demands and collects money pursuant to the terms of his contract, and enjoys all its economic benefits, is scarcely in a position to maintain that he had no fixed right to receive it. In this case, the Studio unquestionably acquired a fixed "right to receive" in the taxable year the amounts which it did collect in that year from students in advance of giving dancing lessons. The amounts admittedly were collected under claim of right, pursuant to its contract with the student, were received without restriction as to their use, and were deposited in its general bank account. (R. 251.) The Studio not only had a right to *receive* the amounts collected, but a right to *retain* them whether or not the lessons paid for were taken; upon cancellation of a contract the Studio normally made no refund of prepaid amounts, thereby realizing substantial "gains from cancellation." (R. 253-256.) Since one who receives money under a claim of right and without restriction as to its use must report it in the year received even though he may be required to refund it in a later year (*Healy v. Commissioner, supra; United States v. Lewis, supra; Security Mills v. Commissioner*), the obligation to perform a contract does not justify the deduction of the anticipated expenses of performance. *Spencer, White & Prentiss v. Commissioner, supra.*

*missioner, supra*), a *fortiori* one who receives it irrevocably must report it in the year received even though he expects to incur future related expenses.

The second premise underlying the Studio's argument, a corollary of the first, disregards the annual accounting requirement and would substitute a transactional system of accounting by permitting a taxpayer to report as gross income from service contracts only that portion of prepaid compensation which he treats as "earned" under the respective contracts during the taxable year.<sup>31</sup> In contending that the federal income tax is imposed only upon "earned" income, which they vaguely define as the result of "matching" items of gross income against "related" items of deduction, the Studio and amici seek to cut across annual accounting periods and employ a "hybrid system, partly annual and partly transactional"—a system which, as this Court held in *Security Mills* (p. 287), finds no place in the statutory scheme for computing federal income tax liability. The situation here is essentially no different from any other in which a taxpayer on the accrual basis receives income in one taxable year, out of which expenses or losses will have to be paid in a later year. Under long settled tax accounting principles, the tax on the income in the year of receipt

<sup>30</sup> Even monies illegally obtained and used are taxable in the year of receipt. See *Rutkin v. United States*, 343 U.S. 130.

<sup>31</sup> That the Studio is advocating a transactional as distinguished from an annual method of accounting is apparent from the example given in fn. 6 (p. 15) of its brief. Moreover, the table set forth in its Exhibit 31 (R. 215), upon which it relies, points up the distortion of its annual net taxable income (gross less deductions), resulting from its deferral of gross income received in one taxable year to a later year through the attempted "matching" of estimated future service expenses.



may not be withheld or diminished by excluding or deducting from the gross income a reserve to cover an estimated amount of anticipated expenses, or losses. See *Brown v. Helvering*, *supra*. Basically the same transactional or "earnings" approach advocated by the Studio was rejected by this Court in the AAA case.<sup>22</sup>

The term "earnings" has never been used in the income tax statutes to describe either the object of the tax or its method of computation or reporting.<sup>23</sup> And

<sup>22</sup> The Second Circuit's decision in *Bressner Radio, Inc. v. Commissioner*, 267 F. 2d 520, typical of the lower courts decisions upon which the amicus relies, appears irreconcilable with its decision in the *Spencer, White & Prentiss v. Commissioner*, 144 F. 2d 45, certiorari denied, 323 U.S. 780. See also *Commissioner v. Fifth Avenue Coach Lines*, 281 F. 2d 556 (C.A. 2d), certiorari denied, 366 U.S. 964. *Bressner* was not followed by the Seventh Circuit in *Streight Radio and Television, Inc. v. Commissioner*, 280 F. 2d 883, certiorari denied, 366 U.S. 965, which presented the same issue. In Rev. Rul. 60-85, 1960-1 Cum. Bull. 181, the Internal Revenue Service announced that it would not follow *Bressner*, stating:

The *Bressner Radio Inc.*, decision conflicts in principle with a long line of judicial authority holding that where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income. \* \* \*

This Court (367 U.S. at 689) predicated its grant of certiorari in the AAA case upon conflict with *Bressner*, and its AAA decision effectively overruled that decision.

<sup>23</sup> Under the 1939 Code (Sections 11 and 12) the tax is imposed on the "net income." The term "net income" is defined in Section 21 as "the gross income computed under section 22, less the deductions allowed by section 23." Section 41 provides that the taxpayer's computation of "The net income" must clearly reflect "the income". The statutory scheme in the 1954 Code is basically the same, except that the term "taxable income" has been substituted for "net income". See Sections 61,

this Court has specifically rejected the notion that "earnings"—rather than annual "net income"—forms the basis of tax accounting. As stated in *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493, 498:

It is true that the acts of Congress taxing income have consistently laid the tax upon the net income received by or accrued to the taxpayer in a "taxable year," which is either the calendar year or a different fiscal year, as the taxpayer may elect. But they have never undertaken to limit the income taxable in any one year to that derived from the taxpayer's activities occurring in that or any other single year. The items of gross income and of allowed deductions to be included in the income return, are those of the taxpayer for his taxable year, even though they may have resulted from or be affected by his business transactions of other years. *Burnet v. Sanford & Brooks Co.*, *supra*, 364, 365. Circumstances wholly fortuitous may determine the year in which income, whenever earned, is taxable, and may thus affect the amount of tax. Receipt of income or accrual of

63, 161-175, 241-247, 441, and 446, Internal Revenue Code of 1954. Compare the use of the term "earnings and profits" in Section 115 of the 1939 Code (Section 316 of the 1954 Code), relating to dividend distributions. As the Tax Court observed in *Streight Radio and Television, Inc. v. Commissioner*, 33 T.C. 127, 138, affirmed, 280 F. 2d 883 (C.A. 7th), certiorari denied, 366 U.S. 965: "Tax accounting does not concern itself with the fine question of whether items have been 'earned' in the accounting sense, \* \* \* and this is true whether the item in question has been received, or is merely a receivable." See also *South Dade Farms v. Commissioner*, 138 F. 2d 818, 819 (C.A. 5th); *Automobile Club of New York v. Commissioner*, 32 T.C. 906, 912, affirmed, 304 F. 2d 781 (C.A. 2d); *Spencer, White & Prentiss v. Commissioner*, *supra*.

the right to receive it within the tax year is the test of taxability, not the time it has taken the taxpayer to earn it \* \* \*.

The transactional or "earnings" theory of tax accounting urged by taxpayer ignores the rationale of the annual accounting rule, to say nothing of the rule itself. As pointed out in *Sanford & Brooks, supra*, and again in *Security Mills*, the annual accounting system is rooted in strong practical and policy consideration—the need of the government for an ascertainable amount of revenue at regular intervals, collectible through a system capable of practical operation. By requiring an accrual basis taxpayer to report gross income when the right to receive it becomes fixed, and to deduct liabilities when all the events have occurred which fix both the fact and amount of the liability, the annual accounting system permits the taxpayer to compute, and the Commissioner to assess, the tax on the basis of facts rather than estimates. Moreover, these standards apply uniformly to accrual basis taxpayers in all types of business situations. The transactional or earnings approach, on the other hand, would place on the Commissioner the enormous burden of evaluating and verifying complex statistical evidence submitted by millions of taxpayers in an endless variety of business contexts to prove that they have reliably "related" and "matched" present income with estimated future expenses, or present expenses with estimated future

income.<sup>24</sup> Revenue agents will not only become involved in technical accounting problems in order to determine the validity and accuracy of the taxpayer's estimates in the first instance, but will be obliged to re-audit the taxpayer's accounts in later years to ascertain whether subsequent business experience corresponds with the taxpayer's previous estimates. And in cases where there is a variance between prior estimates and subsequent experience, adjustments of the resultant understatement or overstatement of actual "earnings" in earlier years, as well as adjustments of the taxpayer's current estimates to assure that past errors will not be perpetuated, will become necessary. Moreover, by "matching" against current income estimated future expenses, the taxpayer may effectively postpone the collection of tax until a later period without any guarantee that he will later be able to pay the tax.<sup>25</sup>

<sup>24</sup> See Schapiro, "Tax Accounting for Prepaid Income and Reserves for Future Expenses," Tax Revision Compendium, submitted to the Committee on Ways and Means (1959), Vol. 2, pp. 1133, 1142-1145.

<sup>25</sup> The difficulties inherent in a system of "matching" future expenses against current receipts are magnified in cases where, as here, indefinite term or lifetime contracts are involved. Moreover, in such cases the "deferred" or "unearned" portion of the prepaid income would not only be increased, but the taxable year to which it would be allocated would be postponed far into the future. In addition, adoption of a "matching" system would pose insurmountable problems of ascertaining how much of the taxpayer's anticipated future overhead expenses (e.g., rent, salaries, entertainment, advertising, utilities, taxes, etc.) are allocable to a particular contract and are to be "matched" against the prepaid income received under that contract, especially in cases where (as here) the taxpayer enters into numerous contracts.

Adoption of the transactional or "earnings" approach would also pose difficult problems for the courts. It would invite litigation as to whether particular items of income and expense are sufficiently "related" to justify their being "matched", either by a deferral of income or the accrual of a reserve for estimated expenses; and, even if there is a discernible relationship between such items, as to whether the tabulations and ratios submitted by the taxpayer, or those prepared by revenue agents, more accurately reflect that relationship. The courts would thus inevitably become embroiled in accounting controversies far more numerous, complex, and time-consuming than those they are now called upon to decide under the annual accounting rule.

(b) *Commercial accounting practices.*—There is no warrant for the amicus' contention (Br. 31-35)<sup>28</sup> that the annual accounting rule and related accrual concepts laid down by this Court in federal income tax cases must yield to commercial (non-tax) accounting principles. It has often been emphasized that generally accepted commercial accounting practices are not controlling for purposes of computing federal income tax liability. *Brown v. Helvering*, *supra*; *Security Mills*, *supra*; *Lucas v. American Code Co.*, 280 U.S. 445; *Bazley v. Commissioner*, 331 U.S. 737, 741; *Commissioner v. Hansen*, 360 U.S. 446; *American Automobile Assn. v. United States*, 367 U.S. 687. Even accounting methods prescribed by federal regulatory agencies to insure compliance with other federal statutes are not determinative of tax

<sup>28</sup> See also fn. 5 (p. 15) of taxpayer's brief.

liability under the Revenue Acts. *Old Colony R. Co. v. Commissioner*, 284 U.S. 552, 562; *Mine Hill & Schuylkill Haven R. Co. v. Smith*, 184 F. 2d 422 (C.A. 3d), certiorari denied, 340 U.S. 932; *Kansas City Southern Ry. Co. v. Commissioner*, 52 F. 2d 372, 378 (C.A. 8th), certiorari denied, 284 U.S. 676. What constitutes a fair and accurate statement of a taxpayer's income in a report to creditors or stockholders, or even for purposes of complying with some other statute, does not necessarily coincide with what must be reported as income under the taxing statute; each report is designed to serve discrete needs and objectives. "Many reserves set up by prudent business men are not allowable as deductions". *Brown v. Helvering*, *supra*, 291 U.S. at 202. As the Court stated in *Weiss v. Wiener*, 279 U.S. 333, 335: "The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer. \* \* \*

In *Spring City Co. v. Commissioner*, 292 U.S. 182, the Court held that an accrual basis taxpayer who sold

<sup>22</sup>The amicus points (Br. 27-28) to a provision in the Treasury Regulations under the 1954 Code (Section 1.446-1(c)(2)) that "generally accepted accounting principles in a particular trade or business \* \* \* will ordinarily be regarded as clearly reflecting income". This is hardly an unqualified approval of all commercial accounting practices. Moreover, the Regulations proceed to explain that an accounting method used by the taxpayer will be acceptable only "if it accords with generally recognized and accepted *income tax accounting principles* and is consistently used by the taxpayer from year to year". (Emphasis added.) Regulations Section 1.446-1(c)(4), Appendix, *infra*, pp. 88-89.



goods to one who became insolvent during the taxable year was required to accrue and report the full sale gain for federal income tax purposes, notwithstanding that under accepted business accounting practices it was proper to defer the portion which the seller did not expect to collect from the insolvent vendee. The Court stated (p. 189-190):

Petitioner insists that "good business practice" forbade the inclusion in the taxpayer's assets of the account receivable in question or at least the part of it which was subsequently found to be uncollectible. But that is not the question here. Questions relating to allowable deductions under the income tax act are quite distinct from matters which pertain to an appropriate showing upon which credit is sought. It would have been proper for the taxpayer to carry the debt in question in a suspense account awaiting the ultimate determination of the amount that could be realized upon it, and thus to indicate the status of the debt in financial statements of the taxpayer's condition. But that proper practice, in order to advise those from whom credit might be sought of uncertainties in the realization of assets, does not affect the construction of the statute, or make the debt deductible in 1920, when the entire debt was not worthless, when the amount which would prove uncollectible was not yet ascertained, rather than in 1923 when that amount was ascertained and its deduction allowed.

Recently, in *Commissioner v. Hansen, supra*, the Court held that an automobile dealer was not entitled to exclude from its gross income a "dealer's reserve", representing a portion of the sales price withheld by finance companies, even though it was the "common

pattern" (p. 448) and "consistent practice" (p. 452) in the trade to treat such reserves as unaccrued and unearned until paid over to the dealer. The more recent decision in *American Automobile Assn., supra*, is directly in point. It was there admitted, by the government (p. 691), as the Court of Claims had found, that the taxpayer's income-deferral method was "in accord with generally accepted [commercial] accounting principles"; nevertheless, the Court held (p. 692) that the method "fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner."

It is noteworthy that for general business purposes the accounting profession has ascribed a meaning to "net income" which differs significantly from the meaning of that term as used in the Internal Revenue Code and consistently applied by this Court. The term has been defined by the American Institute of Accountants (the amici) as synonymous with "earnings" over a "period of years", and as having reference, moreover, to "the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period."<sup>1</sup> Furthermore, the transactional or "earn-

<sup>1</sup>The American Institute of Accountants, in its Accounting Terminology Bulletin No. 2, pp. 3-4 (March, 1955), defines "net income" as follows:

The terms *net income* or *net profit* refer to the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period.

The term *earnings* is not used uniformly but it is generally employed as a synonym for "net income," particularly over a period of years. \* \* \*

ings" method of arriving at "net income", approved by the accounting profession for commercial accounting purposes, entails allocations of "charges and credits" which are "estimated" and are "based on assumptions as to future events which may be invalidated by experience." Such a method of accounting, while it may serve useful business purposes, is completely at odds with settled tax accounting precepts.

In any event, there is no reason to suppose that application of generally accepted commercial accounting practices in the area of prepaid income would more clearly reflect "true" net income for a given tax accounting period than the application of established tax accounting rules. Indeed, the accounting profession itself candidly recognizes that commercial accounting practices are diverse and inexact—that they sanction different procedures, and often produce disparate calculations of net income for a particular period.<sup>20</sup> To substitute the "earned income" theory of accounting espoused by the amici for the annual

<sup>20</sup> As stated by the American Institute of Accountants in its Accounting Research Bulletin No. 43, p. 50 (1953):

Allocations to fiscal periods of both charges and credits affecting the determination of net income are, in part, estimated and conventional and based on assumptions as to future events which may be invalidated by experience. While the items of which this is true are usually few in relation to the total number of transactions they sometimes are large in relation to the other amounts in the income statement.

<sup>21</sup> In a recent article the former President of the American Institute of Certified Public Accountants (the amici in this case) stated:

There is some reason to believe that this phrase—"generally accepted accounting principles"—suggests to the or-

accounting rule and related accrual principles would not, therefore, furnish any practical solution to the accounting problem presented by this case.

Ordinary reader the existence of some authoritative code of accounting, which when applied consistently will produce precise and comparable results. The appearance of precision is strengthened by the reporting of net income in exact dollars and cents, instead of rounded approximations.

Now, we accountants know that "generally accepted accounting principles" are far from being a clearly defined, comprehensive set of rules, which will ensure identical accounting treatment of the same kind of transaction in every case in which it occurs. We know that "generally accepted accounting principles" are broad concepts evolving from the actual practices of business enterprises, and reflected in the literature of the accounting profession. To be sure, many of these principles have been formally defined or clarified in the accounting research bulletins of the American Institute. But we all know that in some areas there are equally acceptable alternative principles or procedures for the accounting treatment of identical items, one of which might result in an amount of net income reported in any one year widely different from the amount an alternative procedure might produce.

Yet, I suspect it would come, as something of a shock to some people to realize that two otherwise identical corporations might report net income differing by millions of dollars simply because they followed different accounting methods—and that the financial statements of both companies might still carry a certified public accountant's opinion stating that the reports fairly presented the results in accordance with "generally accepted accounting principles." Eaton, "Financial Reporting in a Changing Society," 104 *Journal of Accountancy* 21, 26-27 (August 1957); see also Spacek, "Can We Define Generally Accepted Accounting Principles," 100 *Journal of Accountancy* 40 (December 1958); Knauth, "An Executive Looks at Accounting," 103 *Journal of Accountancy* 29 (January 1957); Wienshienk, "Accountants and the Law," 96 *Pa. Law Rev.* 48 (1947).

(c) *The Treasury Regulations.*—The amicus also stresses (Br. 26–30) those provisions of the Treasury Regulations which authorize use of the “accrual” in lieu of the “cash” method of accounting. See Regulations under the 1954 Code Sections 1.446–1, 1.451–1, 1.461–1, Appendix, *infra*, pp. 85–99. But nothing in the Regulations permits a taxpayer who chooses the accrual system to postpone reporting prepaid service income in order to “match” the income against future (yet-to-be-incurred) service expenses. On the contrary, the Regulations explicitly provide that “[u]nder an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.” Regulations Section 1.451–1(a).<sup>31</sup> The succeeding sentence of the Regulations which the amicus emphasizes (Br. 28–29) furnishes no basis for its inference that the Regulations authorize an accrual basis taxpayer to postpone reporting advance receipts for services. It deals with amounts not yet received, and provides that “if” no determination can be made as to the right to receive compensation for services until the services are completed, the compensation ordinarily is income for the taxable year in which the determination can be made. The very sentence relied upon by the amicus contemplates that there may be situations where the taxpayer’s right to receive (and

<sup>31</sup> Conversely, “[u]nder an accrual method of accounting an expense is deductible for the taxable year in which all the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy.” Regulations Section 1.461–1(a)(2).

corresponding duty to accrue) compensation antedates performance of the services. Such a situation exists where, as here, under the terms of the service contract the taxpayer is entitled to and does receive payment in advance for future services. Thus, Rev. Rul. 60-85, 1960-1 Cum. Bull. 181-182, addressed to the precise situation here presented, specifically provides that:

where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income. \* \* \*

Accordingly, the Service will continue its general policy of taxing prepaid income in the year of receipt. This policy applies to income from contracts to furnish services and to other types of prepaid income, such as prepaid royalties, rent, bonuses, etc., regardless of whether the period of proration is definite or indefinite, unless a different treatment is specifically provided in the Internal Revenue Code of 1939 or 1954 or the regulations thereunder.

Moreover, the Treasury Regulations are to be read as a whole, not by isolating one part from another. The interpretation which the amicus places upon the Regulations renders superfluous the long standing provisions of the Regulations specifically authorizing use of either a "percentage of completion" or "completed contract" method of reporting income from "long-term contracts", defined as "building, installation, or construction contracts" covering a period in excess of one year. Regulations 118, Section 39.42-4 under the 1939 Code, Appendix, *infra*, pp. 81-82; Regulations under the 1954 Code, Section 1.451-3,



Appendix, *infra*, pp. 95-96. See also *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 366. No claim is or can be made that the Studio's contracts to furnish dancing lessons constituted "long-term contracts" falling within the purview of the Regulations.

In short, it is the Studio, not the Commissioner, who is seeking to circumvent the "all events" test enunciated in the Regulations and decisions.

(d) *The decisions relied upon by the Studio and amicus.*—Neither the Studio nor the amicus points to any decision which sanctions the deferral, for federal income tax purposes, of prepaid service income. Indeed, the cases upon which they mainly rely (e.g. *United States v. Anderson*, 269 U.S. 422) support the government's position. They involved deduction items, and they hold that such items are deductible on the accrual basis only in the taxable year in which the taxpayer's liability to pay them becomes fixed. In contravention of those decisions the Studio is here attempting, by way of "deferral" of "unearned income", to deduct estimated future service expenses from a current year's gross income.

In *Anderson* the Court sustained the Commissioner's determination that a munitions tax was deductible in the year it was imposed (1916), not in the following year in which it became due and payable, because (pp. 440-441) "all the events" had occurred in the earlier year to "fix the amount of the tax and determine the liability of the taxpayer to pay it."<sup>32</sup>

<sup>32</sup> In *Anderson*, the Court was interpreting T.D. 2433, 19 Treasury Decisions, Internal Revenue 5 (1917), promulgated under Section 13(d) of the Revenue Act of 1916, c. 463, 39

Nothing in the opinion may fairly be read as supporting the proposition that accrual of an item of gross income may be postponed from the taxable year in which it is received under claim of right and without restriction, as to its use until some later year in which related expense items become deductible." To be sure, in *Anderson* (p. 440) the Court spoke of "charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." But when the opinion is read as a whole, and in the light of Stat. 756, wherein Congress for the first time provided that a return might be made in accordance with a taxpayer's books of account, T.D. 2433 limited the accrual of reserves for tax purposes to reserves for liabilities actually "incurred" during the taxable year; reserves for contingent liabilities were expressly disapproved. It further provided that "in cases wherein deductions are made on the accrual basis as heretofore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis."

In the instant case "all of the events" obviously had not occurred in the taxable year to fix the Studio's "liability to pay" for the related expenses of performance which it seeks to match against the advance receipts. For example, compensation to instructors, a major item of expense, was based on the number of hours of lessons actually taught by them (R. 155-156); hence the Studio had no obligation (fixed or otherwise) to pay compensation to an instructor except as and when he gave lessons. The Studio's contractual obligation to students to incur expenses of performance may not be equated with deductible expenses already incurred. See *Spencer, White & Prentiss v. Commissioner*, *supra*; *Starlight Radio and Television, Inc. v. Commissioner*, *supra*. Here as in *Spencer, White & Prentiss* (p. 47), "liability for the work done after" \* \* \* [the taxable year] had not been incurred for the work had not been performed."

of later decisions of this and other courts, it is clear that the Court—far from sanctioning any deferral-of-prepaid income method of accounting—was there strictly applying the annual accounting rule to a taxpayer claiming deductions on the accrual basis. In *Spencer, White & Prentiss v. Commissioner, supra*, which involved essentially the same issue here presented, the Court stated (p. 47):

The petitioner's reliance upon *United States v. Anderson*, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347, is misplaced. There the deduction of certain estimated tax liabilities set up in a reserve entered on the taxpayer's books in accordance with a Treasury Regulation was allowed, though the taxes had not been assessed. But all the events had occurred which determined the liability to pay the tax. Here liability for the work done after \* \* \* [the

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<sup>34</sup> Whatever else may be said of *Anderson*, it continues to be cited by this Court primarily for the proposition that an expense is deductible on the accrual basis only in the taxable year when it is incurred, i.e., when all the events have occurred which fix the liability to pay and determine its amount. *United States v. Consolidated Edison Co.*, 366 U.S. 380, 383; *Dixie Pine Co. v. Commissioner*, 320 U.S. 516, 519; *Aluminum Castings Co. v. Rontzahn*, 282 U.S. 92, 96; *Lucas v. Or. Fibre Brush Co.*, 281 U.S. 115, 120; *Lucas v. American Code Co.*, 280 U.S. 445, 452. See also *Security Mills, supra*, pp. 286-287; *Guaranty Trust Co., supra*, p. 498; *Brown v. Helvering, supra*. Significantly, *Anderson* was relied upon by the Second Circuit in support of the deferral system involved in *Bressner Radio, Inc. v. Commissioner, supra*, but that case, as previously noted, was effectively overruled in *American Automobile Assn. v. United States*, 367 U.S. 687, 689. Cf. concurring opinion of Judge Clark in *Automobile Club of New York, Inc. v. Commissioner*, 304 F.2d 781 (C.A. 2d).

taxable year] had not been incurred for the work had not been performed. \* \* \*

Unless inconsistent accrual principles are to govern for purposes of determining when gross income and deduction items respectively accrue, the "all events" test applied in *Anderson* demands accrual of the income items here in question. For when the Studio received advance payments for lessons to be furnished, pursuant to the terms of its contract with students, "all the events" had occurred to "fix" its right to receive payment and the amount receivable—albeit that in some later year the taxpayer might be required either to refund the income or to incur related deductible expenses. *Security Mills Co. v. Commissioner, supra.*

*Levin v. Commissioner*, 219 F. 2d 588 (C.A. 3d), also relied upon by the Studio (Br. 17-18), likewise involved a deduction item and supports the government's position. It was there held that an accrual basis partnership which contracted in one taxable year to pay for advertising services to be rendered in the following year was not entitled to deduct as an expense of the taxable year the full amount payable under the contract because its liability to pay remained contingent in that year. In this case, as in *Levin*, the Studio is improperly attempting (in the guise of deferral of prepaid income) to deduct service expenses which it had no liability to pay in the taxable year. *Helvering v. Union Pacific Co.*, 293 U.S. 282, also cited by the Studio (Br. 12-15), involved an issue far removed from that here presented; it was there held that a corporation issuing bonds was en-

titled to amortize discount and commission allowed over the life of the bond.

As for the cases involving income accrual, upon which the Studio and amici rely (e.g. *Spring City Co. v. Commissioner*, 292 U.S. 182; *Continental Tied Lumber Co. v. United States*, 286 U.S. 290), they too support the Government's position. They illustrate the proposition that income must be reported on the accrual basis in the year when the "right to receive" it becomes fixed, which of course may precede the year of actual receipt. Nothing in the opinions of those cases even remotely suggests that a taxpayer who receives compensation under a claim of right and without restriction as to its use has no fixed "right to receive" it in the accrual accounting sense merely because it is received for services to be performed in the future.

*B. Congress has authorized only two classes of taxpayers to use a deferral method of accounting for prepaid service income, and the Studio admittedly does not fall within either class*

If more were needed to support the decision below, there are "other considerations requiring our affirmance" (*American Automobile Assn. v. United States*, *supra*, p. 694): (1) the history of the enactment and repeal of 1954 Code Sections 452 and 462, dealing respectively with deferral of prepaid income and deduction of reserves for estimated expenses; and (2) the history of the recent enactments of Sections 455 and 456, permitting income deferral, subject to carefully defined safeguards and limitations, by two specified classes of taxpayers (publishers and mem-

bership organizations)—classes to which the Studio admittedly does not belong.<sup>35</sup>

In the *A.I.A.* case, the court pointed out (p. 695) that Section 452, which permitted deferral of income received for future services, "overruled the long administrative practice of the Commissioner and holdings of the courts in disallowing such deferral of income for tax purposes," and that its repeal the following year—

confirms our view that the method used by the Association could be rejected by the Commissioner. While the claim is made that Congress did not "intend to disturb prior law as it affected permissible accrual accounting pro-

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<sup>35</sup> Nor does the Studio come within any of the specific statutory exceptions to the annual accounting rule. See Section 44 of the Internal Revenue Code of 1939, and Section 452 of the Internal Revenue Code of 1954 (installment sales); Section 122 of the Internal Revenue Code of 1939, and Section 472 of the Internal Revenue Code of 1954 (net operating loss deduction); Section 23(k) of the Internal Revenue Code of 1939, and Section 166 of the Internal Revenue Code of 1954 (bad debt reserves); Sections 201(c)(2) and 202 of the Internal Revenue Code of 1939 (credit for estimated liability reserves of life insurance companies); Sections 802, 803(b) and 804(a), Internal Revenue Code of 1954 (deduction for estimated liability reserves of life insurance companies); Sections 204(b)(6) and (7), (c)(1) and (4), Internal Revenue Code of 1939, and Sections 832(b)(5) and (6), (c)(1) and (4), Internal Revenue Code of 1954 (definitions of "losses incurred" and "expenses incurred" with respect to deductions allowed insurance companies other than life and mutual); Section 461(c), Internal Revenue Code of 1954 (proration of real property taxes related to a definite period of time); Section 171, Internal Revenue Code of 1954 (amortizable bond premium); Sections 1301-1304, Internal Revenue Code of 1954 (long-term compensation).

visions for tax purposes." H.R. Rep. No. 293, 84th Cong., 1st Sess. 4-5, the cold fact is that it repealed the only law incontestably permitting the practice upon which the Association depends. To say that, as to taxpayers using such systems, Congress was merely declaring existing law when it adopted § 452 in 1954, and that it was merely restoring unaffected the same prior law when it repealed the new section in 1955 for good reason, is a contradiction in itself, "varnishing nonsense with the charm of sound." Instead of constituting a merely duplicative creation, the fact is that § 452 for the first time specifically declared petitioner's system of accounting to be acceptable for income tax purposes, and overruled the long-standing position of the Commissioner and courts to the contrary. And the repeal of the section the following year, upon insistence by the Treasury that the proposed endorsement of such tax accounting would have a disastrous impact on the Government's revenue, was just as clearly a mandate from the Congress that petitioner's system was not acceptable for tax purposes. \* \* \*

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<sup>36</sup> It is plain from the Senate Finance Committee's Report accompanying the 1954 Code that Congress understood prepaid service income to be includible in gross income for the year of receipt, whether the taxpayer used the accrual or the cash method of accounting. Thus in explanation of Section 452 ("Prepaid Income"), which authorized substantially the same deferral method of accounting as the Studio here employed, the Report stated (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 301 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4940)):

Under the 1939 Code, *regardless of the method of accounting*, with minor exceptions established by regulations or administrative practice, amounts are includible in gross income by the recipient not later than the time of receipt



The Court further pointed out (p. 696) that the later addition of Section 455, permitting publishers to defer prepaid subscription income, coupled with denial of similar relief to automobile clubs with respect to prepaid membership dues, made it abundantly clear that Congress did not intend to grant such relief generally to all taxpayers. Moreover, since the AAA decision, Congress has re-confirmed that intention by adding to the Code a section specifically authorizing—again with carefully delineated restrictions and safeguards—automobile clubs and certain other membership organizations to defer prepaid dues income for taxable years after 1960. Section 456 of the 1954 Code, added by Section 1, Act of July 26, 1961, 75 Stat. 222. See H. Rep. No. 381, 87th Cong., 1st Sess. (1961-2 Cum. Bull. 390). Significantly, omnibus bills designed generally to permit deferral of income received for future services have been introduced in the Congress, but have not been passed.

Thus the accounting problem which this case presents has been under continuing legislative study, and Congress has chosen to deal with the problem on

if they are subject to free and unrestricted use by the taxpayer even though the payments are for goods and services to be provided by the taxpayer at a future time. *Emphasis ours.*

As this Court pointed out in its AAA opinion (367 U.S. at 695-697), the repeal of 1954 Code Section 452 within a year after its enactment reinstated the law as it existed under the 1939 Code.

<sup>7</sup> See H.R. 8688, 86th Cong., 1st Sess., and H.R. 2245 and 2440, 87th Cong., 1st Sess., referred to the Ways and Means Committee, each a bill "To amend the Internal Revenue Code of 1954 to provide for the deferment of income from service contracts".

a. selective step-by-step basis, and even as to the two classes singled out for special treatment it has imposed conditions and limitations for the protection of the revenue. Given this pattern of legislative activity, we submit that it would be highly inappropriate for the courts to attempt to carve out additional exceptions to the annual accounting rule in favor of classes of taxpayers other than those specified in the statute. In the concluding words of this Court in *AAA* (p. 697):

To recapitulate, it appears that Congress has long been aware of the problem this case presents. In 1954 it enacted § 452 and § 462, but quickly repealed them. Since that time Congress has authorized the desired accounting only in the instance of prepaid subscription income, which, as was pointed out in *Michigan*, is ratably earned by performance on "publication dates after the tax year." 353 U.S. 180, 189, note 20. It has refused to enlarge § 455 to include prepaid membership dues. At the very least, this background indicates congressional recognition of the complications inherent in the problem and its seriousness to the general revenue. We must leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications. The Committees of the Congress have standing committees expertly grounded in tax problems, with jurisdiction covering the whole field of taxation and facilities for studying considerations of policy as between the various taxpayers and the necessities of the general revenues. The validity of the long established policy of the Court in deferring, where possible, to congressional pro-

cedures in the tax field is clearly indicated in this case. \* \* \*

The policy expressed in A.A.A. of leaving to Congress the determination when, and in what circumstances, income deferral is permissible applies with equal force to the deferral system of accounting employed by the taxpayer here. If dance studios—or, for that matter, any taxpayer other than a publisher or membership organization qualifying under 1954 Code, Sections 455 and 456—are to be permitted to defer the reporting of income otherwise currently includible in gross income, the authorization and the concomitant protective provisions should come from Congress, not the courts.<sup>38</sup>

<sup>38</sup> The "complications inherent in the problem" and its "wide ramifications", to which the Court adverted in the A.A.A. case (p. 697), are numerous. To mention but a few: (1) If the reporting of service income is deferred beyond the taxable year in which received, should not the deduction of expenses paid or incurred in that year, but attributable to the deferred income, also be deferred? (2) How define a "service contract"; *e.g.*, should it embrace a contract for the use of property, or a sale accompanied by a service warranty? (3) How deal with two discrete service liabilities created by a single contract, one to be performed in the current year and the other over several years? (4) Over how long a period should income-deferral be permitted in the case of long-term or lifetime service contracts?

The impact upon the revenue must also be considered. A change from current to deferred reporting would involve important one-time adjustments, and in many cases result not only in reduced tax liability for the year of transition, but in creating a net operating loss carry-back or carry-forward to other years. Consideration should also be given to requiring the revenue loss in the year of transition to be spread over several years.

*C. Assuming arguendo that taxable income may be computed on a transactional rather than an annual basis, the Studio's method of accounting was properly rejected as even more artificial than that rejected in American Automobile Assn. v. United States.*

Thus far we have argued, as we did in the A.A.A. case, that *any* system of accounting which fails to report prepaid service income in the taxable year of receipt, even though the income has not yet been "earned" by performance of the service paid for in advance, is contrary to the scheme of federal income taxation and may be rejected by the Commissioner. This Court in A.A.A. apparently agreed, for it held that the income-deferral system there involved "fails to respect the criteria of annual tax accounting", and transgressed the clear Congressional "mandate" (manifested by repeal of 1954 Code, Sections 452 and 462) rendering such systems "not acceptable for tax purposes". 367 U.S. at 692, 695. However, it sustained the Commissioner's rejection of the Association's deferral system on the *further* ground that it was "purely artificial", i.e., "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year." 367 U.S. at 691. See also *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 189, note 20.

If, as we submit, any system of deferral of prepaid service income (other than those specifically authorized by the special provisions of 1954 Code, Sections 455 and 456) must be rejected as violating settled tax accounting principles, then there is no need to determine whether the particular system of deferral employed by the taxpayer should be rejected on the

alternative and independent ground that it is "artificial". But even assuming *arguendo* that such an inquiry were necessary, we submit that the Studio's system of accounting was no less artificial than that condemned in *American Automobile Assn.*

In the first place, the Studio's contracts did not provide for the giving of lessons on fixed dates after the taxable year, but left such dates to be arranged from time to time by the student and his instructor. In fact, many students paid for lessons without ever demanding or arranging that they be given, with the result that a substantial part of the taxable income returned by the Studio each year was attributable to "Gains from cancellation" of contracts rather than "Earned Income". (R. 256.) "Gains from cancellation", of course, represented monies which the Studio had collected (either in advance or in installments) for lessons which it had not been, and never would be, called upon to give.<sup>10</sup> Thus, the record establishes beyond question that the Studio's right to receive (and retain) the advance payments was in no way contingent upon the actual performance of services. On the contrary, it establishes that the Studio's liability to perform services was entirely contingent upon the student's demands. In the words of this Court in *American Automobile Assn.* (p. 692), "no, some, or all the services paid for \* \* \* may or may

<sup>10</sup> Refunds which the Studio occasionally made were charged against "Deferred Income" before "Gains from cancellation" were computed. (R. 253.) Accordingly, "Gains from cancellation" represent the Studio's "unearned" profit from its contracts after allowance of refunds.

not be rendered", and there was no "fixed individual expense or performance justification" for its accounting system.

Furthermore, the Studio's accounting system carries a feature which stamps it as even more artificial than the Association's. Whereas the Association treated certain operating expenses (*e.g.*, commissions paid to personnel for selling contracts to members) "as prepaid membership costs and deducted [them] ratably over the same periods of time as those over which dues were recognized as income" (367 U.S., p. 690), the Studio deducted all of its "related" expenses in the taxable year they were paid or incurred, without regard to when the amounts received under its contracts were reported as "earned." Commissions to sales personnel, for example, were deducted when paid, as were the percentage royalties paid to Arthur Murray on each week's receipts. (R. 218-219, 252.) Consistency would require that these expenses, instead of having been deducted in the year of payment, should have been treated as deductions only in the subsequent year in which the "related" gross income items were treated as "earned." Under its accounting system, however, the Studio was claiming the best of both worlds—immediate deduction of expenses and deferral of "related" gross income. The Commissioner, we submit, was amply justified in rejecting such a system of accounting.

In any event, whether or not the Studio's system is deemed artificial, we think it is clear that the "long standing position of the Commissioner and courts",

and the repeal of the "only law incontestably permitting the practice upon which the \* \* \* [Studio] depends" (367 U.S. at 695) fully justifies the Commissioner's refusal to approve the Studio's method of accounting for advance receipts.

## II. THE FUTURE INSTALLMENTS

THE STUDIO WAS REQUIRED TO ACCRUE AND REPORT FUTURE INSTALLMENTS REPRESENTING SERVICES RENDERED DURING THE YEAR (REGARDLESS OF THE CONTRACTUAL DATE FOR PAYMENT) AND FUTURE INSTALLMENTS DUE UNDER THE CONTRACT DURING THE YEAR (REGARDLESS OF THE CONTRACTUAL OR ACTUAL DATE OF PERFORMANCE).

The burden of our argument thus far has been that payments actually received without restriction as to use must be deemed accrued income. But, in addition to supporting this proposition, most of the authorities already discussed also teach that income often accrues *before* receipt—when the right to receive becomes fixed. Ordinarily, it is performance of the services which fixes the amount and the right to receive payment. But, exceptionally, the parties may agree otherwise. The contract may provide that the right to payment antedates the obligation to perform.

As we have seen, that is the situation here. These atypical contracts "call for downpayment of a por-

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\* In this connection it may be noted that at least one state (California) has recently enacted legislation designed to prevent dance studios from engaging in practices which result in forfeitures of advance payments. Declaring that "the purpose" of such legislation is "to safeguard the public against fraud, deceit, imposition and financial hardship \* \* \* by prohibiting or restricting false or misleading advertising, onerous contract terms, harmful financial practices \* \* \* by which the public has been injured in connection with contracts for health and dance studio services", the California statute (1) prohibits



tion of the stipulated price and installment payments of the balance, without regard to when, or whether, lessons will actually be requested by the students. Neither the amounts payable nor the due dates of the installments bear any relationship to the number of lessons expected to have been given at the time of payment. Normally, payments were made when due and the rule applicable to actual receipts would apply. But there were, of course, defaults and delays in payments. These are our present concern.

Under the circumstances of this case, it is clear that the right to receive accrued, at the latest, when payment became due under the agreement, even though not then made. Neither the creditor's failure to demand payment, nor the debtor's refusal to pay, can affect the legal right to receive a matured installment. And, under settled principles, once that right has ripened, income is deemed accrued. The consequence is that accrued income in any given year includes: (1) payments actually received, (2) payments presently

dance studios from entering into contracts measured by the life of the person receiving the service; from requiring payments over a period exceeding two years from the date of the contract or in a total amount exceeding \$500, and from cutting off defenses by assignment of the contract or negotiation of notes received thereunder; and (2) requires every contract for dance studio services to contain a provision for refund of prepayments, and for relief from further payments, upon the death or disability of the person contracting for the service. Title 2.5, California Civil Code (Sections 1812.80-1812.95), added by Stat. 1961, c. 1675, § 1.

due under the contract, and (3) promised compensation for services already performed, regardless of the contractual date for payment.

Initially, the Commissioner went further, asserting that installment payments should be accrued even before they become due, since the signing of the contract itself fixed the amount and the right to ultimately receive them. Upon reconsideration, however, we concede the error of accruing future payments which are neither due as a matter of contract, nor matured by performance of the related services. Indeed, the Studio's right to collect the installment on its due date depends, in its continuing ability and willingness to perform. Until that time, its right to receive payment has not fully ripened.

Because neither the Commissioner nor the taxpayer segregated amounts received, matured installments, and payments not yet due, disposition of the case on the basis outlined will require re-examination of the studio's books and records and appropriate new findings. Accordingly, we urge a remand of the cause for this purpose.

#### CONCLUSION

For the foregoing reasons, it is respectfully submitted (1) that the judgment of the court of appeals should be affirmed in so far as it is predicated upon inclusion in the Studio's gross income for the respec-

tive taxable years involved of the amounts received by it in those years in cash or its equivalent; and (2) that the case should be remanded for a determination of the additional amounts includible by reason of its having acquired a fixed right to receive them in those years.

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## APPENDIX

### Internal Revenue Code of 1939:

#### SEC. 21. NET INCOME.

(a) *Definition.*—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

\* \* \* \*

(26 U.S.C. 1952 ed., Sec. 21.)

#### SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

\* \* \* \*

(26 U.S.C. 1952 ed., Sec. 22.)

#### SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services

actually rendered; \* \* \* and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(c) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

- (1) if incurred in trade or business; or
- (2) if incurred in any transaction entered into for profit, though not connected with the trade or business; \* \* \*

(26 U.S.C. 1952 ed., Sec. 22.)

#### SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule*.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. \* \* \*

(26 U.S.C. 1952 ed., Sec. 42.)

#### SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. \* \* \*

(26 U.S.C. 1952 ed., Sec. 43.)

#### SEC. 48. DEFINITIONS.

When used in this chapter—

(a) *Taxable Year*.—"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. \* \* \*

(c) *"Paid or Incurred"*, *"Paid or Accrued"*.—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part. \* \* \*

(26 U.S.C. 1952 ed., Sec. 48.)

## Internal Revenue Code of 1954:

## SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

- (1) Compensation for services, including fees, commissions, and similar items;
- (2) Gross income derived from business;
- (3) Gains derived from dealings in property;
- (4) Interest;
- (5) Rents;
- (6) Royalties;
- (7) Dividends;
- (8) Alimony and separate maintenance payments;
- (9) Annuities;
- (10) Income from life insurance and endowment contracts;
- (11) Pensions;
- (12) Income from discharge of indebtedness;
- (13) Distributive share of partnership gross income;
- (14) Income in respect of a decedent; and
- (15) Income from an interest in an estate or trust.

(b) *Cross References.*—

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

(26 U.S.C. 1958 ed., Sec. 61.)

## SEC. 63. TAXABLE INCOME DEFINED.

(a) *General Rule.*—Except as provided in subsection (b), for purposes of this subtitle the



term "taxable income" means gross income, minus the deductions allowed by this chapter, other than the standard deduction allowed by part IV (sec. 141 and following).

(26 U.S.C. 1958 ed., Sec. 63.)

#### SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home; but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of \$3,000.

(26 U.S.C. 1958 ed., Sec. 162.)

#### SEC. 165. LOSSES.

(a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and \* \* \*

\* \* \* \* \*

(26 U.S.C. 1958 ed., Sec. 165.)

#### SEC. 441. PERIOD FOR COMPUTATION OF TAXABLE INCOME.

(a) *Computation of Taxable Income.*—Taxable income shall be computed on the basis of the taxpayer's taxable year.

(b) *Taxable Year.*—For purposes of this subtitle, the term "taxable year" means—

(1) the taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(2) the calendar year, if subsection (g) applies; or

(3) the period for which the return is made, if a return is made for a period of less than 12 months.

(c) *Annual Accounting Period.*—For purposes of this subtitle, the term "annual accounting period" means the annual period on the basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar Year.*—For purposes of this subtitle, the term "calendar year" means a period of 12 months ending on December 31.

(e) *Fiscal Year.*—For purposes of this subtitle, the term "fiscal year" means a period of

12 months ending on the last day of any month other than December. In the case of any taxpayer who has made the election provided by subsection (f), the term means the annual period (varying from 52 to 53 weeks) so elected.

(26 U.S.C. 1958 ed., Sec. 441.)

#### SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) *Permissible Methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) *Taxpayer Engaged In More Than One Business.*—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before com-

puting his taxable income under the new method, secure the consent of the Secretary or his delegate.

(26 U.S.C. 1958 ed., Sec. 446.)

#### SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) *General Rule.*—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

(26 U.S.C. 1958 ed., Sec. 451.)

#### SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) *General Rule.*—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

(26 U.S.C. 1958 ed., Sec. 461.)

Treasury Regulations 118 (1939 Code):

#### SEC. 39.41-1 *Computation of net income.*—

Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a

manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

SEC. 39.41-2 *Bases of computation and changes in accounting methods.*—(a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 39.42-2 and 39.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 39.22(c)-5.)

(b) The true income, computed under the Internal Revenue Code, and if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 39.22(c)-1 to 39.22(g)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 39.42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 39.22(a)-7 and 39.23(a)-11). Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the

beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. See section 22(d) and §§ 39.22(d)-1 to 39.22(d)-7, inclusive, with respect to changing to the last-in first-out method of inventorying goods.

(d) Section 44 contains special provisions for reporting the profit derived from the sale of property on the installment plan.

(e) The foregoing requirements relative to a change of accounting method are not applicable if a taxpayer desires to adopt the installment basis of returning income, as provided in §§ 39.44-1 and 39.44-3, but are applicable if a taxpayer desires to change from such basis to a straight accrual basis. In cases where permission to make such change is granted, the taxpayer will be required to return as additional income for the taxable year in which the change is made all the profit not theretofore returned as income pertaining to the payments due on installment sales contracts as of the close of the preceding taxable year.

SEC. 39.41-3. *Methods of accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and § 39.54-1.) Among the essentials are the following:



(a) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22(c) and §§ 39.22(c)-1 to 39.22(c)-8, inclusive);

(b) Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(c) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses.

SEC. 39.41-4. *Accounting period.*—The return of a taxpayer is made and his income computed for his taxable year, which in general means his fiscal year, or the calendar year if he has not established a fiscal year. (See section 48.) The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December. No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. A person having no such fiscal year must make his return on the basis of the calendar year. Except in the case of a first return for income tax a taxpayer shall make his return on the basis upon which he made his return for the taxable year immedi-

ately preceding unless, with the approval of the Commissioner, he has changed his accounting period. See § 39.46-1.

Sec. 39.42-1 *When included in gross income*—(a) *In general*. Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. See §§ 39.41-4 to 39.41-3, inclusive. \* \* \*

Sec. 39.42-4 *Long-term contracts*. (a) Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section, the term "long-term contracts" means buildings, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(1) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

(2) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

(b) A taxpayer may change his method of accounting to accord with subparagraphs (1) and (2) of paragraph (a) of this section only after permission is secured from the Commissioner as provided in § 39.41-2.

SEC. 39.43-1. "*Paid or incurred*" and "*paid or accrued*." (a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as

the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

SEC. 39.43-2 *When charges deductible.* Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. \* \* \*

#### Treasury Regulations on Income Taxes (1954 Code)

1.41-1 PERIOD FOR COMPUTATION OF TAXABLE INCOME.—(a) *Computation of taxable income.*—Taxable income shall be computed and a return shall be made for a period known as the "taxable year." For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see sections 446 to 482, inclusive, and the regulations thereunder.

(b) *Taxable year.* (1) the term "taxable year" means—

(i) The taxpayer's annual accounting period, if it is a calendar year or a fiscal year;

(ii) The calendar year, if section 441(g) (relating to taxpayers who keep no books or have no accounting period) applies; or

(iii) The period for which the return is made, if the return is made under section 443 for a period of less than 12 months, referred to as a "short period."

(2) A taxable year may not cover a period of more than 12 calendar months except in the case of a 52-53-week taxable year. See § 1.441-2.

(3) A new taxpayer in his first return may adopt any taxable year which meets the requirements of section 441 and this section without obtaining prior approval. The first taxable year of a new taxpayer must be adopted on or before the time prescribed by law (not including extensions) for the filing of the return for such taxable year. However, for rules applicable to the adoption of a taxable year by a partnership, see § 1.442-1(b)(2), section 706(b), and § 1.706-1(b). For rules applicable to the taxable year of a member of an affiliated group which makes a consolidated return, see § 1.1502-14 and § 1.442-1(d).

(4) After a taxpayer has adopted a calendar or a fiscal year, he must use it in computing his taxable income and making his returns for all subsequent years unless prior approval is obtained from the Commissioner to make a change or unless a change is otherwise permitted under the internal revenue laws or regulations. See section 442 and § 1.442-1. For rules applicable to changes in taxable years of partners and partnerships, see also section 706(b) and § 1.706-1(b):

(c) *Annual accounting period.*—The term "annual accounting period" means the annual period (calendar year or fiscal year) on the

basis of which the taxpayer regularly computes his income in keeping his books.

(d) *Calendar year*.—The term "calendar year" means a period of 12 months ending on December 31. A taxpayer who has not established a fiscal year must make his return on the basis of a calendar year.

(e) *Fiscal year*.—(1) The term "fiscal year" means—

(i) A period of 12 months ending on the last day of any month other than December, or

(ii) The 52-53 week annual accounting period, if such period has been elected by the taxpayer.

(2) A fiscal year will be recognized only if it is established as the annual accounting period of the taxpayer and only if the books of the taxpayer are kept in accordance with such fiscal year.

(g) *No books kept; no accounting period*.

Records which are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books.

SEC. 1446-1. GENERAL RULE FOR METHODS OF ACCOUNTING.—(a) *General rule*.—(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such

methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable



year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return as, for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see sections 471 and 472, and the regulations thereunder.)

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

(iii) In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, ~~or~~ depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

(b) *Exceptions.*—(1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(2) A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

(c) *Permissible methods.*—(1) *In general.*—Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.*—Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451-2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and § 1.461-1(a)(1).

(ii) *Accrual method.*—Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by

the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise, the extent to which indirect costs shall be included in computing cost of goods sold depends upon the method used by the taxpayer in treating such items in keeping his books.

(iii) *Other permissible methods.*—Special methods of accounting are described elsewhere in chapter 1 of the Internal Revenue Code and the regulations thereunder. For example, see the following sections and the regulations thereunder: Sections 61 and 162, relating to the crop method of accounting; section 453, relating to the installment method; section 451, relating to the long-term contract methods. In addition, special methods of accounting for particular items of income, and expense are provided under other sections of chapter 1. For example, see section 174, relating to research and experimental expenditures, and section 175, relating to soil and water conservation expenditures.

(iv) *Combinations of the foregoing methods.*—(a) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all

other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

(b) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

(2) *Special rules.*—(i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the Income Tax Regulations if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the Income Tax Regulations, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. See section 446(a) and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on

the basis of which the taxpayer regularly computes his income in keeping his books, and section 446(c) and paragraph (c) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

(d) *Taxpayer engaged in more than one business.*—(1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

(e) *Requirement respecting the adoption or change of accounting method.*—(1) A taxpayer

filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this section. See also section 446(a) and paragraph (a) of this section.

(2)(i) Except as otherwise expressly provided in chapter 1 of the Internal Revenue Code of 1954 and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured, whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him, unless such consent is secured.

(ii) Examples of changes requiring consent are: A change from the cash receipts and disbursements method to an accrual method, or vice versa; a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder); a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451-3); a change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; or a change in

the treatment of any other items of income or expense, where material.

(3) In order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application by letter with the Commissioner of Internal Revenue, Washington 25, D.C., within 90 days after the beginning of the taxable year in which it is desired to make the change. The application shall be accompanied by a statement specifying the nature of the taxpayer's business, his present method of accounting, the method to which he desires to change, the taxable year in which the change is to be effected, the classes of items which would be treated differently under the new method, and all amounts which would be duplicated or omitted as a result of the proposed change. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions and adjustments under which the change will be effected. See section 481 and regulations thereunder, relating to certain adjustments required by such changes, section 472 and the regulations thereunder, relating to changes to and from the last-in, first-out method of inventorying goods, and section 453 and the regulations thereunder, relating to certain adjustments required by a change from an accrual method to the installment method.

SEC. 1451.1 GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.—(a) *General rule.*—Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of ac-



counting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in the prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and § 1.706-1(a). If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation,

file claim for credit or refund of any overpayment of tax arising therefrom.

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**SEC. 1451.3 LONG-TERM CONTRACTS.—(a)**

*Definition.*—The term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted.

(b) *Methods.*—Income from long-term contracts (as defined in paragraph (a) of this section), determined in a manner consistent with the nature and terms of the contract, may be included in gross income in accordance with one of the following methods, provided such method clearly reflects income:

(1) *Percentage of completion method.*—Gross income derived from long-term contracts may be reported according to the percentage of completion method. Under this method, the portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year shall be included in gross income for such taxable year. There shall then be deducted all expenditures made during the taxable year in connection with the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable year for use in such contract. Certificates of architects or engineers showing the percentage of completion of each contract during the taxable year shall be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return.

(2) *Completed contract method.*—Gross income derived from long-term contracts may be reported for the taxable year in which the contract is finally completed and accepted. Under this method, there shall be deducted

from gross income for such year all expenses which are properly allocable to the contract, taking into account any material and supplies charged to the contract but remaining on hand at the time of completion.

(c) *In general.*—Long-term contract methods of accounting apply only to the accounting for income and expenses attributable to long-term contracts. Other income and expense items, such as investment income or expenses not attributable to such contracts, shall be accounted for under a proper method of accounting. See section 446(c) and § 1.446-1(c). A taxpayer may change to or from a long-term contract method of accounting only with the consent of the Commissioner. See section 446(c) and § 1.446-1(c). When a taxpayer reports income under a long-term contract method, a statement to that effect shall be attached to his income tax return.

SEC. 1461-1. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.—(a) *General rule.*—(1) *Taxpayer using cash receipts and disbursements method.*—Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in

which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 263 and the regulations thereunder for rules relating to capital expenditures. 4

(2) *Taxpayer using an accrual method.*—

Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims \$10,000. B admits the liability to A for \$7,000 but contests the remainder. B may accrue only \$7,000 as an expense for the taxable year in which the services were rendered. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken

into account for the later taxable year in which such determination is made.


(3) *Other factors which determine when deductions may be taken.*—(i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

(ii) Where there is a dispute and the entire liability is contested, judgments on account of damages for patent infringement, personal injuries or other causes, or other binding adjudications, including decisions of referees and boards of review under workmen's compensation laws, are deductions from gross income when the claim is finally adjudicated or is paid, depending upon the taxpayer's method of accounting. However, see subparagraph (2) of this paragraph.

(iii) For special rules relating to certain deductions, see the following sections and the

regulations thereunder: Section 1481, relating to accounting for amounts repaid in connection with renegotiation of a government contract; section 1341, relating to the computation of tax where the taxpayer repays a substantial amount received under a claim of right in a prior taxable year; and section 165(e), relating to losses resulting from theft.

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comes fixed, the right accrues." It has always been the position of the petitioners that "the right to receive" became fixed when earned by performance of the services. In his brief (pp. 66-67) the respondent contends that "the right to receive" became fixed at various times, (1) when an advance payment is actually received; or (2) when a payment becomes due, even though not made; or (3) when services are performed. Accordingly, the issue to be resolved is what is meant under accrual accounting principles by the term "the right to receive."

The respondent, at pages 19 and 20 of his brief, sets forth the following definition of accrual accounting:

" \* \* \* Under the accrual method, gross income items are reported in the year in which the right to receive them becomes fixed, even though they are not immediately receivable, *but no later than the year of actual receipt*; conversely, deduction items are reported in the year in which they are incurred, i.e., when the liability to pay becomes fixed in fact and reasonably ascertainable in amount, even though payment is not then due, *but no later than the year of actual payment.*" [Italics supplied.]

In order to place the Studio on a cash basis with respect to advance receipts and to justify his position that income accrues when payments are received, the respondent has added the italicized phrases to the definition of accrual accounting. Under the accrual method of accounting, advance receipts are taken into account as income when earned by performance. It is not concerned with the receipt of payments nor the flow of cash.

Not only is the respondent's definition in conflict with the proper definition of accrual accounting, but it is also at odds with the decisions of this Court and the

definition of the accrual method set forth in Treasury Regulations. See Brief of Amicus, pp. 18-25; Treas. Reg. 118, § 39.41-2(a) and § 39.42-1(a) under 1939 Code; Treas. Reg. § 1.446-1(c)(ii) and § 1.451-1(a) under 1954 Code. Appendix, Brief for Petitioners at pp. 9a-11a. If the accrual method of accounting requires a taxpayer to include as income all receipts "no later than the year of actual receipt," then those decisions and regulations authorizing the use of the accrual accounting method must be overturned.

Likewise, the respondent's definition of the accrual of deduction items is in error when it states that they are reported in the year in which incurred even though payment is not then due, "but no later than the year of actual payment." For example, an accrual basis taxpayer must prorate rent paid in advance over the period for which the rent was paid;<sup>1</sup> he must prorate expense for fire and other insurance premiums over the period covered by the insurance policy;<sup>2</sup> interest prepaid must be deducted over the period to which the prepayment relates and not entirely in the year of payment.<sup>3</sup> Similarly, expenses incurred in obtaining a loan must be amortized over the period of the loan.<sup>4</sup>

<sup>1</sup> See *Bloddy's Jewelry, Inc.* (1925), 2 B.T.A. 611; *Main & McKinnier-Building Co. v. Commissioner* (CA 5, 1940), 113 F. 2d 81; *Baton Coal Co.* (1930), 19 B.T.A. 169, *aff'd.* (CA 3, 1931), 51 F. 2d 469; *Galatoire Bros. v. Louis* (CA 5, 1928), 23 F. 2d 676; *J. Allard & Bro., Inc. v. United States* (D.C. Mass., 1928), 28 F. 2d 792.

<sup>2</sup> *Higginbotham-Bailey-Logan Co.* (1927), 8 B.T.A. 566; *Two-L Realty Co., Inc.*, T.C. Memo., Oct. 31, 1955; 55,297 P-H Memo. T.C.

<sup>3</sup> I.T. 3740, C.B. 1945, p. 109.

<sup>4</sup> *Longview-Hilton Hotel Co.* (1947), 9 T.C. 180, *acq.* 1947-2, C.B. 3. Cf. *Helvering v. Union Pacific Railroad Co.* (1934), 293 U.S. 282.

Even the respondent apparently recognizes that the addition to the rule relating to the accrual of deductions is not valid in all cases since he attempts to except the decision of this Court in *United States v. Consolidated Edison Co.* (1961), 366 U. S. 380, from his rule.<sup>5</sup> The foregoing authorities are sufficient to show that it is not the law that the accrual of a deduction may never follow the year of payment. On the contrary, where a payment is for an expense which relates to a period after the close of the taxable year, a deduction may not be taken in the year of payment but must be taken in the year to which the expense relates.

The Commissioner of Internal Revenue has recognized in some instances advance receipts need not be reported as income in the year received. See I.T. 3369, 1940-1, C.B. 46, where prepaid subscriptions to periodicals were permitted to be spread over the subscription period; I.T. 2080, III-2 C.B. 48 (1924) where payments for tickets were received by travel agent in one year for cruises to be taken in the following year were not to be reported as income in year of receipt under accrual method of accounting which was the only method that clearly reflected income.<sup>6</sup> Moreover, both the Tax Court and the Commissioner have approved the deferral of advanced payments as income where goods were to be delivered in a subsequent year. See *Veenstra & DeHaan Coal Co.* (1948), 11 T.C. 964; acq. 1949-1 C.B. 4; cf. *Summit Coal Co.* (1930), 18 B.T.A. 983; *Woodlawn Park Cemetery Co.* (1951), 16 T.C. 1067; acq. 1951-2 C.B. 4.

<sup>5</sup> See footnote 13\* (p. 20) of Brief for the Respondent.

<sup>6</sup> These rulings demonstrate that the Commissioner recognized that under accrual accounting it was proper to defer income, and that legislation such as section 452 of the 1954 Code was not necessary.

From the standpoint of common justice, as well as from the standpoint of accrual accounting, there is no justification for a different treatment of advance receipts where services are involved rather than goods. In both instances, the cost of the goods sold or the cost of rendering the services cannot be incurred until the succeeding year, so that deferral is essential in order to match receipts with related expense to clearly reflect income.

Likewise, respondent's second test for determining when income accrues, i.e., when payments become due under the contracts, even though not then made, is wrong and in direct conflict with decisions of this Court since *United States v. Anderson* (1926), 269 U. S. 422. See also *American National Co. v. United States* (1927), 274 U. S. 99; *Niles-Bement-Pond Co. v. United States* (1930), 281 U. S. 357; *Aluminum Castings Co. v. Routzahn* (1930), 282 U. S. 92. Cf. *Brown v. Helvering*, 291 U. S. 193. Under these cases, the test for determining when income accrues is not concerned with a scheduled due date in "a technical legal sense." Rather, the test under the statute is to be made in an "economic and bookkeeping sense." It is significant to note that the position the Government is now taking in the case at bar is diametrically opposite to its position in the *Anderson* case. In that case, the Government's brief (See Brief for the United States in *United States v. Yale & Towne Mfg. Co.*, pp. 31-32, No. 420 Supreme Court, October Term, 1925 [companion case to *Anderson*]) stated its position as follows:

" \* \* \* The basic idea under the accrual system of accounting is that the books shall immediately reflect obligations and expenses definitely incurred

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IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1962

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No. 80.

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MARK E. SCHLUDE and MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

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**REPLY BRIEF FOR PETITIONERS**

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**I. REPLY TO RESPONDENT'S ARGUMENT THAT THE  
TIME WHEN INCOME ACCRUES IS EITHER (1) WHEN  
PAYMENT IS RECEIVED, OR (2) WHEN PAYMENT  
BECOMES DUE, OR (3) WHEN SERVICES ARE  
PERFORMED.**

The respondent (Br. 13 and 67) concedes that the Commissioner and the Courts below erred in treating the entire amount of the contract as having accrued at the time the contract was executed. While this concession has narrowed the issue, the basic issue remains — When does income accrue under the accrual method of accounting? In *Spring City Foundry Co. v. Commissioner* (1934), 292 U. S. 182, the question was answered: "When the right to receive an amount be-



and income *definitely earned* without regard to whether payment has been made or whether payment is *due*. Under this system, the use of the word "accrued" does not signify that the item is *due*. On the contrary, the accrual system wholly disregards *due* dates. \* \* \* [Italics added.]

The Court obviously adopted the Government's position in the *Anderson* case when it held that the munitions tax accrued in 1916 under the "all events" test, although the tax was not assessed nor due until 1917.

The third test offered by the respondent for determining when income accrues, i.e., at the time services are performed, is correct. The taxpayers agree this is the time when the fixed right to receive "ripened" or was "realized", or "earned." Furthermore, this is the time the Studio accrued income under the contracts with the students, whether or not actual payments had been received. Looking at the problem from an "economic and bookkeeping sense," the right to receive could only come into being at the time the services were rendered. This is the time when the labor was performed that produced the income.

The respondent's multi-test formula for determining when income accrues<sup>7</sup> fails to satisfy the "all events" test. Under the "all events" test, the time an item is determined to be income is when all events have

<sup>7</sup> Respondent includes in his concept of what accrues as income the entire face amount of the notes transferred to the bank with full recourse, irrespective of payment dates and the amount held by bank in reserve. He does not consider the fact that the notes are stated to be "Negotiable Note Given for Tuition" (see Sections 62-303—62-305, Revised Statutes of Nebraska 1943, Reissue of 1958, Appendix 21-22) or whether they are given merely as evidence of a contractual obligation, or other factors affecting the market value or collectibility of the notes.

occurred which fix the right to receive such income. This is a time certain, it either is or is not income at a particular time; and if it is, it cannot be income at any other time. Therefore, respondent's alternate time test is in conflict with the "all events" test. Much confusion would result from use of the respondent's multi-formula test as compared with the simplicity of the "all events" test. Under the "all events" test, income would accrue at the time it was "earned" by the rendering of the service.

## II. REPLY TO RESPONDENT'S ARGUMENT THAT THE STUDIO'S METHOD OF ACCOUNTING VIOLATES THE ANNUAL ACCOUNTING REQUIREMENT

The respondent contends (Br. 18-56) that the Studio's accrual method of accounting violates the annual accounting requirement of the statute. His argument in this respect is the same that was made and rejected by this Court in *American Automobile Association v. United States* (1961), 367 U.S. 687.<sup>\*</sup> Nothing can be said in this reply brief as to the invalidity of the respondent's argument regarding the violation of the annual accounting requirement of the statute that was not fully covered in the dissenting opinion in *American Automobile* where it was said: (p. 702)

" \* \* \* The underlying premise of the annual accounting requirement is that *otherwise reportable income* derived from a transaction cannot be excluded from gross income in order to let the taxpayer wait to see in a later year how the overall transaction turns out. That is not the issue in

<sup>\*</sup> See dissenting opinion of Mr. Justice Stewart, 367 U.S. 687, at p. 701, where it is stated: "The Court today does not base its decision on this theory, ['annual accounting requirement'] presumably because the Court believes, as I do, that the theory is not valid."

this case. The question here is whether any reportable income has been derived from a transaction when payments are received in advance of performance." [Italics the Court.]

### III. REPLY TO RESPONDENT'S ARGUMENT THAT THE CLAIM OF RIGHT DOCTRINE IS APPLICABLE AS A COROLLARY OF THE ANNUAL ACCOUNTING RULE

The respondent contends (Br. 28-31) that the claim of right doctrine is a "corollary" to the annual accounting rule, and that the two theories working together lend strong support to the Government's position. In *American Automobile*, the respondent, pointing to the dissenting opinion of Mr. Justice Harlan in *Automobile Club of Michigan v. Commissioner*, 353 U. S. at 191-192, agreed that the so-called "claim of right doctrine" was not applicable.<sup>9</sup> The dissenting opinion in *American Automobile* at 699-700, specifically points out that the Government abandoned the claim of right doctrine in that case. Once, again, nothing further can be said in this reply brief as to the fallacy of the respondent's argument based upon the claim of right doctrine that has not been fully covered in the dissenting opinion of *American Automobile* and *Michigan* cases.

### IV. REPLY TO RESPONDENT'S ARGUMENT BASED ON THE LEGISLATIVE HISTORY OF THE ENACTMENT AND REPEAL OF SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954

The respondent argues (Br. 56-61) that the enactment and repeal of sections 452 and 462 of the Internal Revenue Code of 1954 support the decision below. The

<sup>9</sup> See pages 35-36, Brief for the United States in *American Automobile Association v. United States*, No. 288, Supreme Court, October Term 1960.

petitioners' answer to this argument appears at pages 26 and 27 of their brief. In addition, it should be pointed out that congressional action in enacting and repealing sections 452 and 462 did not have any effect on sections 41 and 42 of the 1939 Code or sections 446 and 451 of the 1954 Code. These are the statutory provisions authorizing accrual accounting and the time when items shall be taken into account. Section 42 states generally that items of gross income shall be included for the taxable year received—*"unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period."* \* \* \* Section 41 was designed specifically to authorize accrual accounting. Section 42 was designed specifically to authorize that aspect of accrual accounting relating to the time when items are to be included in income. It is the petitioners' position that the issue here to be decided must be reached by interpreting sections 41 and 42 of the 1939 Code and 446 and 451 of the 1954 Code, and that the enactment and repeal in 1954 and 1955 of sections 452 and 462 has no relevancy to whether the taxpayers' method of accounting clearly reflects income.

**V. REPLY TO RESPONDENT'S ARGUMENT THAT THE  
STUDIO'S METHOD OF ACCOUNTING MUST BE RE-  
JECTED AS BEING ARTIFICIAL**

The respondent (Br. 62-65) argues that the Studio's method of accounting was artificial because (1) contracts did not provide for the giving of lessons on fixed dates after the taxable year, and were thus contingent on the student's demand, and (2) the Studio deducted certain expenses in the taxable year they were paid or incurred, without regard to when the amounts received under the contracts were reported as earned.

With respect to the first point, failure to provide for fixed dates, the appointments for lessons were not as haphazard as the respondent would indicate. Each of the contracts required that the lessons be taken within a definite period of time. (R. 146-149.) While no schedule of lessons was set forth in the contracts, the lessons were scheduled from lesson to lesson in a routine manner.<sup>10</sup> (R. 227.) In *Automobile Club of Michigan v. Commissioner* (1957), 353 U. S. 180, *Schuessler v. Commissioner* (CA. 5, 1956), 230 F. 2d 722, was distinguished because "performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year." In *Schuessler*, furnaces were to be turned on in the fall and turned off in the spring for a five-year period. It is common knowledge of everyone who uses a gas furnace that the user calls the service man and agrees on a date for turning on or turning off the furnace, depending upon weather conditions. The scheduling of dancing lessons by the Studio was much more "fixed" than in *Schuessler*.<sup>11</sup>

Intertwined with his argument on "fixed dates" is one respecting the Studio's liability to perform services contingent upon the students' demands. The respond-

<sup>10</sup> It is illogical to assume, as does the respondent, that the time for lessons was left entirely contingent upon the student's demands. During 1952, 1953 and 1954 the Studio taught 17,436, 28,436 and 39,159 hours of lessons, respectively. (R. 191.) If a routine schedule or standing appointment for lessons were not in existence, the large number of hours of lessons could not have been taught and confusion would have prevailed as to time of appointments between student and teacher.

<sup>11</sup> On this point, assuming *arguendo* the respondent was factually correct, it is not vital to taxpayers' case. See Brief Amicus, pp. 37-40.

ent is twisting the facts for this argument. (Br. 63.) The Studio sold services, i.e., dancing lessons. The students at the time of entering into the contract fully intended to take and receive the lessons they paid for. They were not paying for the privilege of having a dance studio available or instructors available to give lessons. They were paying for lessons. Consequently, the Studio was not selling the mere availability of service. Respondent made a similar argument earlier in his brief at page 34 when he points out that a large proportion of the lessons contracted for are never taken. (See footnote 1, Pet. Br. p. 5.) However, with respect to paid-up lessons, approximately 90.5% of such lessons were taken. (See below, footnote 13.) The only uncertain part of the transaction was with respect to lessons contracted for but never paid for by the students. The contingency was whether the student would perform his part of the contract by making the payments. The accrual of income by the Studio had no bearing or relationship to total lessons contracted for. As each unit of the contract is performed, i.e., as each hourly lesson is actually rendered, it was reported as income notwithstanding the fact that some or a part of a contract might have been altered or actually cancelled. It was similar to a contract calling for future delivery of goods at specific or sporadic intervals within a definite contract period. As the goods are actually identified and shipped, the unit price times the quantity is invoiced and income therefrom accrued. This is true notwithstanding that the balance of the contract may be cancelled or renegotiated for a higher or smaller amount or the terms thereof in any way changed. The actual event which gave

rise to the income was the shipment of goods and not the terms of the contract.<sup>12</sup>

The respondent can hardly be serious in urging these minor and inconsequential objections to the accuracy of the Studio's accrual accounting method. We refer first to respondent's argument (Br. 63) that a substantial part of the Studio's income was attributable to gains on cancellations.<sup>13</sup> In other words, the respondent's argument is that when a student breached the contract by failing to pay, or failing to take the lessons within the prescribed time, this proves that the Studio's liability to perform is contingent. The situation that arises upon breach of contract by the student is not a fair criterion to conclude that petitioners' obligation to perform under the contracts is contingent.

The second point respondent makes is that commissions to sales personnel and royalties paid to Arthur Murray were deducted when paid instead of in the subsequent year in which related income was treated as earned. The Tax Court made a specific finding of fact on expenses as follows: (R. 252.)

<sup>12</sup> It is incorrect to state, as was stated at page 34 of the respondent's brief, that the Studio's per lesson method of accrual is based on the false assumption that all lessons contracted for will be taken. Under the method of accrual used by the Studio, it made no difference whether none, part, or all of the lessons were taken; the method of accrual used takes income into account on the basis of actual lessons given. This is a fact and not based on any assumption or conjecture.

<sup>13</sup> Gains on cancellations during 1952, 1953 and 1954 were 15.7%, 7.4% and 8%, respectively, or an average of about 9.5% of gross income derived from tuition fees. (R. 211.) Therefore, of the lessons paid for, approximately 90.5% were earned through performance of services.



"(4) Expenses were recorded and deducted in the periods incurred except that the 10 per cent royalties to Arthur Murray, Inc., and certain other items were recorded and deducted when paid. (Actually many of these amounts were also incurred at about the same time as when paid.)" [Parentheses the Court's.]

The Tax Court recognized how these expenditures were accounted for (R. 251) but made no finding that the Studio's method of accounting was artificial. The Tax Court must have recognized that these expenses were overlapping items and fall within Treasury Regulations 1.461-1(3) which in part provides:<sup>14</sup>

"\* \* \* However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account."

It is clear that respondent's objections of such a nature have no merit. Plainly, the Studio business was the type of business that had no difficulty in recording the revenue from each contract and the cost of performing under each contract. It was thus able to meet the requirements set forth in *American Automobile* with regard to the matching of receipts with the cost to perform. This case should be decided on whether "[A]ny system of deferral of prepaid service income \* \* \* must be rejected as violating settled tax accounting principles, \* \* \*<sup>15</sup> rather than on inconsequential objections to the accrual method employed.

<sup>14</sup> See Treas. Reg. 1.461-1, set forth in full in Brief for Respondent, pp. 96-99.

<sup>15</sup> See Brief for the Respondent, p. 62.

**VI. REPLY TO RESPONDENT'S ARGUMENT THAT AN ACCURATE ACCRUAL METHOD OF ACCOUNTING FOR ADVANCE RECEIPTS WOULD UNDULY BURDEN THE ADMINISTRATION OF THE TAX LAWS**

Although the taxing statutes<sup>16</sup> give the taxpayer a choice as to the accounting method to be employed, the respondent in substance argues that the Studio must use a cash basis for reporting advance receipts because an accrual method would result in a burden in the administration of the laws. The Brief for the Respondent at pages 42-43 states:

\*\*\* \* The transactional or earnings approach, on the other hand, would place on the Commissioner the enormous burden of evaluating and verifying complex statistical evidence submitted by millions of taxpayers in an endless variety of business contexts to prove that they have reliably "related" and "matched" present income with estimated future expenses, or present expenses with estimated future income. \*\*\*

Even though the cash method of accounting is easier to administer than the accrual method, the respondent cannot compel a taxpayer to use a cash method unless the taxpayer's method does not reflect true income. The choice of the method to be used is the taxpayer's, not the Commissioner's. Administrative convenience cannot prevail over the statutory right given the taxpayer. Aside from the legal right supporting the taxpayer's position, the use of the accrual method of accounting where advance receipts are involved, is not as complex as the respondent assumes. On the accrual basis, the time for including items in income is de-

<sup>16</sup> Sections 41 and 42, Internal Revenue Code 1939, and sections 446 and 451, Internal Revenue Code 1954.

terminated by the delivery of goods or the rendition of services. This is not a difficult test to be applied. A merchant or a manufacturer, using the accrual method, who receives payments in advance, would defer taking the payments into income until the time of delivery of the goods. Applied to a business rendering services, such as the Studio's, advance receipts are includible as income in the taxable year the services are rendered. This is the period when the income is earned. Certainly these rules are not complex. The use of these standard accounting rules consistently over the years results in clearly reflecting a taxpayer's true income.<sup>17</sup>

#### VII. REPLY TO RESPONDENT'S BRIEF IN GENERAL

Throughout his brief, the respondent bases his arguments on assumptions and presumptions that are not based on facts or justified by the record in this case. For example, the respondent refers to the advance receipts as "income" or "compensation" when received.<sup>18</sup> In this regard he completely ignores the fact that this case involves accrual and not cash accounting. The respondent's argument is misleading and not justi-

<sup>17</sup> The respondent at footnote 25, page 43, (also Br. 36) intimates that the Studio indefinitely defers income on so-called "lifetime courses." This is not true. Lifetime courses are for a specified number of hours, either 1,000 or 1,200 hours. In addition, such a student was entitled to two hours of lessons per month, plus two parties per year for life.<sup>19</sup> (R. 184, 250.) However, at the end of the specified 1,000 or 1,200 hours, all income under the contract would have been included in earned income and reported for tax purposes. Aside from lifetime courses, the record shows that income is not indefinitely deferred; rather most of the deferred income at the end of any fiscal year represents current year's sales. (R. 212-213.)

<sup>18</sup> Brief for Respondent, pp. 16-17, 24-25, 27, 28-29, 30, 34-36, 37, 38, 39, 42, 52, 62, 66.

fied by the record when he states the Studio "prorated" the contract price.<sup>19</sup>

The respondent's brief speaks of "reserves"<sup>20</sup> or a deduction for an "estimated future service expense."<sup>21</sup> Under the accrual method of accounting, there are two systems that may be employed for purposes of matching expenses against receipts: (1) deferring a portion of the advance receipts properly earned in a later period, and (2) setting up a suitable reserve to cover future cost related to receipts accounted for in an earlier period. For all practical purposes, the two methods accomplish the same result, i.e., matching of expenses against receipts. Illustrative of cases involving accrual accounting where advance receipts were deferred are: *American Automobile Association v. United States* (1961), 367 U.S. 687; *Automobile Club of Michigan v. Commissioner* (1957), 353 U.S. 180; *Beacon Publishing Co. v. Commissioner* (CA 10, 1955), 218 F. 2d 697; *Bressner Radio, Inc. v. Commissioner* (CA 2, 1959), 267 F. 2d 520; *Bayshore Gardens, Inc. v. Commissioner* (CA 2, 1959), 267 F. 2d 55. Cases involving the accrual method of accounting in which a reserve was set up to cover future cost related to receipts accounted for in an earlier period are: *Schuessler v. Commissioner* (CA 5, 1956), 230 F. 2d 722; *Harrold v. Commissioner* (CA 4, 1951), 192 F. 2d 1002; *Denise Coal Co. v. Commissioner* (CA 3, 1959), 271 F. 2d 930; *Hilinski v. Commissioner* (CA 6, 1956), 237 F. 2d 703; and *Pacific Grape Products Co. v. Commissioner* (CA 9, 1955, 219 F. 2d 862.

<sup>19</sup> Brief for Respondent, p. 14.

<sup>20</sup> Brief for Respondent, pp. 39-40, 44, 45, 46.

<sup>21</sup> Brief for Respondent, pp. 25-26, 33, 34, 36, 42, 43, 52, 55.

While either the deferring of advance receipts or reserving for future expenses perform the same function, i.e., matching expenses against receipts, they should not be equated one with the other. Which practice should be followed to clearly reflect income depends on the particular problem presented. As a general rule, good accounting practice calls for establishing a reserve for future expense, rather than deferring advanced receipts where the product or service the accrual basis taxpayer is obligated to supply in a future year is *incidental* to the main transaction, and fulfillment of the obligation is not a separate income-producing activity. This is the situation where a large majority of the performance required has already been rendered and the income resulting from such performance recognized and accrued. On the other hand, good accounting practice calls for deferring advance receipts where the product or service the accrual basis taxpayer is obligated to supply in a future year is the main transaction or principal income producing activity. The deferral practice is the only practice in such a situation which will achieve the reporting of income in the year in which it is earned through performance of services. It should be pointed out that the Studio, in following good accounting practice, deferred advance receipts. The giving of the dancing lessons was the Studio's principal income activity. It cannot be said to be incidental. The Studio deferred taking into income the advance payments for dance instruction until the lessons were given. At the time the lesson was given, the income was earned and the operating cost known. The right to the income did not become fixed and absolute until it was earned through the performance of services which created the right to the income. Consequently, in the instant case there were no actual re-

services set up nor were there any actual estimates of future expenses. All deductions were based on fact rather than estimates.

Finally, the respondent's brief fails to discuss the meaning and real purpose of the statutory provisions applicable to this case. He does not deny that sections 41 and 42 of the Internal Revenue Code of 1939 and sections 446 and 451 of the Internal Revenue Code of 1954 are applicable,<sup>22</sup> but he fails to discuss their meaning and significance. Section 42 states:<sup>23</sup>

"The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period.* \* \* \*"<sup>24</sup>  
[Italics supplied.]

This is the statutory authority for deferring income under the accrual method of accounting. A cardinal principle of accrual accounting is that advance receipts do not constitute income until such time as goods are delivered or services rendered. The respondent refuses to recognize this important aspect of accrual accounting, thereby ignoring that part of section 42 which is in italics above. Congress did not use these words meaninglessly or without reason. These words were

<sup>22</sup> Brief for Respondent, pp. 18-19. <sup>a</sup>

<sup>23</sup> Similarly, see section 451 of the 1954 Code.

<sup>24</sup> Section 41 requires that the method of accounting used by the taxpayer in keeping his books shall govern the computation of his net income. It is only when the method of accounting used by the taxpayer in keeping its books does not clearly reflect the income that the Commissioner has a discretion to compute his tax by another method.

placed in the statute because the accrual accounting method as distinguished from cash accounting is not concerned with the flow of cash. It is concerned rather with when the right to receive becomes fixed and certain. The statute recognizes that money may be received before the right to it becomes fixed. The statute clearly says that income is includable in the year of receipt *unless*, under a method of accounting permitted under section 41 (an accrual method is permitted under section 41); such amounts are to be properly accounted for as of a different period. This provision of the statute conclusively disproves the respondent's addition to the definition of accrual accounting<sup>25</sup> which would require the accrual as income of all receipts in the year received. This Court, in *Burnet v. Sanford & Brooks Co.* (1931), 282 U. S. 359, recognized that all advance receipts need not be returned in the year received. It was there stated: (p. 363).

\*\*\* \* \* The amount of all such items [income derived from business] is required to be included in the gross income for the taxable year in which received by the taxpayer, unless they may be properly accounted for on the accrual basis under § 212(b). See *United States v. Anderson*, 269 U. S. 422; *Aluminum Castings Co. v. Rontzahn*, 282 U. S. 92, ante 234."

The respondent's brief confuses and misleads its reader because it quotes as authority cases that factually have no bearing on the issue here presented. The

<sup>25</sup> Brief for Respondent, p. 19, states: "Under the accrual method, gross income items are reported in the year in which the right to receive them becomes fixed, even though they are not immediately receivable, but no later than the year of actual receipt;

• • •" [Italics supplied.]



quotes are not only out of context, but often are from cases involving cash basis taxpayers and not accrual basis.<sup>26</sup> The only cases cited involving advance receipts are the *Automobile Club of Michigan v. Commissioner* (1957), 353 U. S. 180, and *American Automobile Association v. United States* (1961), 367 U. S. 687, which we have distinguished in Brief for Petitioners, pp. 18-26. Furthermore, practically all the cases cited by the respondent presented factual situations that showed the income in question had been earned by the delivery of goods or the rendering of services.<sup>27</sup>

### CONCLUSION

For the foregoing reasons and those expressed in petitioners' original brief, the decision of the Court of Appeals for the Eighth Circuit should be reversed.

Respectfully submitted,

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December 4, 1962.

<sup>26</sup> *Guaranty Trust Co. v. Commissioner* (1938) 303 U.S. 493; *Burnet v. Sanford & Brooks Co.* (1931), 282 U.S. 359; *Healy v. Commissioner* (1953), 345 U.S. 278; *Heiner v. Mellon* (1938), 304 U.S. 271; *United States v. Lewis* (1951), 340 U.S. 590.

<sup>27</sup> *North American Oil Consolidated v. Burnet* (1932), 286 U.S. 417; *Brown v. Helvering* (1934), 291 U.S. 193; *United States v. Lewis* (1951), 340 U.S. 590; *Healy v. Commissioner* (1953), 345 U.S. 278; *Commissioner v. Hansen* (1959), 360 U.S. 446; *Spring City Foundry Co. v. Commissioner* (1934), 292 U.S. 182.

## APPENDIX

Revised Statutes of Nebraska, 1943, Reissue 1958.

Chapter 62—Negotiable Instruments

Article 3, Miscellaneous Provisions

Sections 62-303—62-305

62-303. *Tuition notes or contracts of business colleges; requirements; limitation upon negotiation.* It shall be unlawful for any proprietor, officer, agent or representative of any business college, or the business or commercial department of any school doing business within the State of Nebraska, or without the state when operating or soliciting within the state, to contract for or receive for tuition or scholarship a negotiable note or negotiable contract, unless such negotiable note or notes or negotiable contract shall have printed in red ink prominently and legibly and in twenty-four point bold type diagonally across the face thereof, and above the signatures thereto, the words "negotiable note given for tuition" if a note, or the words "negotiable contract note given for tuition and scholarship," if a contract, and unless a copy of said instrument shall be delivered to the makers thereof at the time of signing the same. It shall be unlawful for any such proprietor, agent or representative of any such school or department to sell or dispose of any such negotiable note or negotiable contract note, receive in payment for tuition or scholarship, prior to three days from the entrance and personal registration of the student, for whom the same was purchased, in the matriculation register at the place of the location of the school or department.

62-304. *Violations; penalty.* Any person who shall violate any of the provisions of section 62-303 shall be deemed guilty of a misdemeanor, and upon conviction

tion thereof shall be punished for every offense by a fine of not less than one hundred dollars and not more than five hundred dollars; or by imprisonment in the county jail not to exceed sixty days, or by both such fine and imprisonment.

62-305. *Tuition notes or contracts of business colleges; when void.* Any note or contract taken by any business college, or the business or commercial department of any other school, or by their agents or representatives, for tuition or scholarships, without first having complied with all the provisions of section 62-303, shall be void.

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STATEMENT OF AMICUS CURIAE AMERICAN  
INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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OFFICE OF THE AMICUS CURIAE

December 3, 1962

IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1962

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No. 80

MARK E. SCHLUDE and M. AZALEH SCHLUDE

Plaintiffs,  
v.  
COMMISSIONER OF INTERNAL REVENUE

---

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT  
OF APPEALS FOR THE EIGHTH CIRCUIT.

---

**STATEMENT OF AMICUS CURIAE AMERICAN  
INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**

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The arguments of the parties require the Court to decide whether the accrual method of accounting (which has to do only with accounting for income as earned) may hereafter be used with respect to advance receipts for income tax purposes. The Institute submits this brief Statement in order to clarify the basic question that issue presents.

That question is: whether, in repeatedly ruling that an accrual basis taxpayer is taxed when he has the "right to receive" income, the Court has held that the "right" arises, as the Institute urges, only in the taxable year in which the receipts are earned, whether previously paid or yet to be paid, or, as respondent contends, that the "right" arises no later than the taxable year of receipt.

The briefs make clear that the parties are in sharp disagreement over the meaning of literally every decision of this Court that bears on this question—the decisions involving tax accounting for advance receipts and for deductions by accrual basis taxpayers. As previously set forth at length (*Amicus Br.* pp. 18-25), we believe the position of the Institute is fully supported by those decisions once it is agreed that *American Automobile Association v. United States*, 367 U.S. 687, decided only that the particular method of accrual accounting there involved was so imprecise that the Commissioner's decision to set it aside was not arbitrary. Because further review of the decisions would be superfluous, we urge only that the Court finally resolve this key issue in order to avoid a most wasteful controversy that otherwise will continue without respite between accrual basis taxpayers and the Commissioner.

The Court should be aware, however, that if the term "right to receive" is given the meaning respondent urges, accrual accounting of advance receipts for income tax purposes will have been eliminated. Simply stated, the fundamental concept that underlies accrual accounting, insofar as it determines when receipts are to be recognized as income, is the taxpayer's earning of

that income by performing services or providing goods, as the case may be. That concept will lose all signifi-

If the earning of income rather than receipt determines the year of taxability, then the Court need pay scant attention to respondent's strenuous effort (Br pp 10, 34) to label the *Schlude* taxpayers' method of accrual accounting for advance receipts as the use of a "reserve for future expenses". Respondent could then make no point of the fact that analytically the portion of the advance receipts not recognized as income until a subsequent tax year included two elements: recovery of the cost of performance and realization of an anticipated profit; and that recognition of the profit as income is postponed until the tax year in which the cost of performance is incurred.

Although respondent correctly states that deferring recognition of receipts as income until earned by performance excludes both elements from taxable income in the year of receipt (Br p 26, n 15), the result is entirely proper once the accounting relationship between such deferral and the use of reserves for future expenses is understood. Insofar as the application of accepted principles of accrual accounting is concerned, the determination of which technique is appropriate in any business context will depend upon the nature of the taxpayer's business and what relationship the advance receipts bear to it.

As a general rule, a reserve for future expenses rather than deferring the recognition of advance receipts would be used where the product or service the taxpayer is obligated to supply in subsequent tax years represents a material obligation but is not sufficiently substantial in relation to the main income-producing transaction to require deferral of the receipts and future fulfillment of this obligation is not a separate income-producing activity. By contrast, if the cost of performance element of the advance receipts is a substantial and significant part of the taxpayer's income-producing activities, accrual accounting recognizes that he can earn the profits embraced by these receipts only by expending the cost of performance. Hence, recognition of those profits as income is deferred until the subsequent period in which the requisite cost of performance is incurred. Admittedly, where a taxpayer receives a single payment for all goods or services he supplies, and all aspects of those goods or services represent his income-producing activity, it may become a fine question whether deferring the recognition of advance receipts or the use of reserves for future expenses is more appropriate. See Shapiro, D., *Tax Accounting*



cance for tax purposes if respondent's position prevails. And there will be no rational basis for stopping. For the Court will be inevitably compelled to abandon also the correlative principle of accrual accounting, clearly enunciated in *United States v. Anderson*, 269 U.S. 422, and in *United States v. Consolidated Edison Co.*, 366 U.S. 380, that expenses are to be taken as deductions only in the tax year in which the taxpayer's obligation to pay is determined, and substitute instead respondent's rule that expenses must be taken as deductions no later than the tax year in which paid.<sup>2</sup>

The practical consequence of respondent's position is that accrual basis taxpayers will be placed on the cash basis to the extent they receive advance payments or anticipate the payment of expenses incurred. This will introduce a wholly unwarranted distinction between those taxpayers' business accounting practices

for Prepaid Income and Reserves for Future Expenses. Compendium of Papers on Broadening the Tax Base. House of Representative Committee on Ways and Means, 85th Cong., 2d Sess., vol. 2, pp. 1133-1134 (1959). However that may be, deferral was quite proper in the *Schlude* situation, since the taxpayers' costs of performance were directly keyed to their major business activity—providing dance instruction services.

<sup>2</sup> The bizarre nature of respondent's new rule concerning deductions may be readily illustrated. If a lease that runs for more than one tax year obligates the lessee to prepay several years rent when the lease is entered into, or if an insurance policy for a period of years requires the insured to pay all premiums when the policy is issued, respondent's view now apparently is that such expenses must be taken as deductions in the year in which they are paid. Respondent fails to indicate how this rule will affect the well-established precedents that require such prepaid expenses to be deducted over the period of years to which they relate. See, e.g., *Baton Coal Co.*, 19 B.T.A. 169 (1930), *aff'd*, 51 F.2d 469 (3d Cir. 1931); *Bloedel's Jewelry, Inc.*, 2 B.T.A. 611 (1925); *Higginbotham-Bailey Logan Co.*, 8 B.T.A. 566, 571 (1927).

and their accounting for income tax purposes. Whatever description may fit that new method of accounting, it will not be accrual accounting and it should not be denominated as such.

\* \* \* \* \*

Any consideration of respondent's position would be deficient if it did not touch upon the gross errors in respondent's repeated reliance (Br. pp. 20, 23, 26-27, 28, 30, *et seq.*) upon the "claim of right" doctrine and upon the "annual accounting requirement" to buttress its reading of the Court's decisions.

a. *The "Annual Accounting Requirement."* No decisions of this Court cited by respondent suggest that the "annual accounting requirement" compels an accrual basis taxpayer to treat advance receipts as income in a taxable year without regard to whether such receipts *become* income in that year by reason of their having been earned by the taxpayer's performance. In confusingly urging that advance receipts must be treated as income no later than the year of receipt simply because the "annual accounting requirement" demands that result, respondent merely assumes the conclusion of its argument. At best respondent supports that conclusion with a barrage of disjointed quotations from numerous cases the relevance of which to the problem at hand is not explained by respondent (Br. pp. 20-28). In truth, as applied to advance receipts, the "annual accounting requirement" comes into play only when there has first been a determination on the basis of wholly independent tax accounting considerations that such receipts have accrued (by the taxpayer's performance) in a particular taxable year and thus are income for that reason. Then and only then does the "annual accounting requirement" direct

the accrual basis taxpayer to report such receipts as income in that year.<sup>3</sup> See *American Automobile Ass'n v. United States*, 367 U.S. 687, 701-702 (dissenting opinion); *Harrold v. Commissioner*, 192 F. 2d 1002, 1006 (4th Cir. 1951).

Most significantly, moreover, respondent's contention that the "annual accounting requirement" demands that accrual basis taxpayers treat all receipts as income no later than the year of receipt studiously avoids giving any content to Section 451 of the Internal Revenue Code of 1954 (Sec. 42(a), 1939 Code). That section explicitly authorizes receipts to be included as

<sup>3</sup> No other explanation can be given for language such as appears in *United States v. Lewis*, 340 U.S. 590, 592, a case involving a cash basis taxpayer that respondent cites without discussion (Br. p. 27), where this Court obviously recognized a clear distinction in the application of the "annual accounting requirement" to cash basis and to accrual basis taxpayers. Thus, when the Court stated that "income taxes must be paid on income received (or accrued) during an annual accounting period," it could only have meant that for an accrual basis taxpayer the annual accounting period in which income must be reported is determined by the year in which receipts "accrue" and not the year in which the taxpayer comes into possession of such receipts. (Emphasis added.) The same conclusion is to be drawn from the Court's statements in *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, another decision that respondent discusses at length in connection with the annual accounting requirement (Br. pp. 20, 21, 42, 52). In a part of the opinion that respondent disregards when it quotes only language which had a bearing upon the cash basis status of the taxpayer in that case (Br. p. 21, n. 14), the Court stated (at p. 363) that items of gross income are "required" to be included in the gross income for the taxable year in which received by the taxpayer, unless they may be properly accounted for on the accrual basis. The Court thus again indicated its awareness that the annual accounting requirement does not mean that accrual basis taxpayers must recognize receipts as income no later than the year of receipt.

income for a taxable year other than the year of receipt if such amount is to be properly accounted for as of a different period under the method of accounting the taxpayer uses in computing taxable income. Respondent cites (Br. pp. 2, 19, 76) but never addresses itself to the meaning of this provision. See our prior Brief, pp. 26-27.

b. *The "Claim-of-Right" Doctrine.* Respondent does not ask the Court to rely directly upon the "claim-of-right" doctrine to rule as it urges. Instead, respondent asserts that the "rationale" of that doctrine "lends strong support" to its position (Br. p. 30). Respondent's circumspection is understandable.

Respondent, of course, is aware that as a basis for the position it espouses, the "claim-of-right" doctrine was discredited by both *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, and *American Automobile Ass'n v. United States*, 367 U.S. 687. Even the majority members of the Court refused respondent's invitation to rest the decisions on that doctrine. Thus in the *Michigan Automobile Club* case Mr. Justice Harlan's dissent succinctly noted that the Court had "bypassed the Commissioner's 'claim-of-right' argument." 353 U.S. at p. 192. Indeed, the statement in respondent's brief in the *American Automobile* case (p. 35) that the "claim-of-right doctrine is not directly applicable" in determining what tax year advance receipts are to become income apparently prompted Mr. Justice Stewart, writing for the four dissenting members in that case, to state that respondent had "with good reason" "abandoned" the doctrine. 367 U.S. at p. 700. As both Justices pointedly declared, the doctrine is of course controlling to determine whether particular receipts are includible in gross income, but

is not relevant in determining the proper taxable year for including as income receipts that indisputably constitute items of gross income.

Once again, as with the "annual accounting requirement," respondent would subject the Court to a tyranny of confused meanings. Respondent's course, we suggest, would lead the Court to hold that rules of law having obvious application in one context may be transported in their entirety to a wholly different context and be relied upon as equally persuasive authority there. Respondent's lengthy argument of both the "annual accounting requirement" and "claim-of-right" does not squarely deal with the question that is truly at issue: what the Court has meant by its statement in numerous decisions that amounts which an accrual basis taxpayer has in fact received or has yet to receive are to be taxed as income only in the tax year in which the taxpayer has a "right to receive" such amounts.

Respectfully submitted,

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